

THE CENTURY STUDIES IN ECONOMICS
WILLIAM H. KIEKHOFER, EDITOR

Public Finance

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WILLIAM H. KIEKHOFFER, *Editor*

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Public Finance

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Fourth Edition

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Preface

Ten years have elapsed since publication of the third edition of this book. An earlier revision would have been warranted, in view of the evolution of the author's thinking, and the developments in domestic fiscal policies. The second World War made postponement necessary, until now.

It is impossible, at this time, to do more than describe the financial aspects of the war, and this has been done, in summary fashion. Its impact upon government finance, as upon all other aspects of civilized life, will be felt far into the future. Evaluation of these effects must wait for clearer perspective than anyone now has.

During the past ten years, various alien fiscal doctrines have gained an increasing degree of acceptance here. They seem to be new, but they are really old and highly discredited doctrines. Since John Law, to go no farther back into history, there has been a succession of those whose stock in trade has been the same old nostrum—easy money. New labels on an old package do not make the contents new, or better, or more worth trying.

The essential theme of these doctrines, in their current version, is statism, that dreadful thing for the removal of which from the earth we have fought two devastating wars. The proposals for using the fiscal powers to influence, or control, or direct the economy along some road laid out by the planners necessarily mean a despotic control of the fortunes and the destinies of all men. Acceptance of such a program involves the subordination of all other values and objectives to security. No man or group of men—whether public officials, or labor leaders, or business managers—should ever have enough power over other men to provide them complete security, for complete security provided by any superior authority entails complete loss of individual freedom. In gaining security by such means we shall become prisoners, at large, of the state.

The point of view expressed in this book is the exact opposite of that represented by these alien fiscal doctrines. Instead of presenting spending, taxing, and borrowing as the way to the abundant life, this book says, in substance, "There is no free lunch." It says that we can have abundance, but we must first produce it. In order that there shall be production at

a level that will mean abundance for all, we must reduce public budgets, ease tax burdens, and release the energies and incentives of the people by letting them spend more of their income while government spends less of it. In short, this book agrees with Grover Cleveland's wise saying that the people should support the government rather than be supported by it.

Grateful acknowledgment is made here to two members of the Tax Foundation staff. Jo Bingham, research specialist in social security and welfare, supplied the material in Chapter V relative to the operation of the plans for a variable federal grant. Vera Knox, librarian, was indefatigable in providing documentary material and in compiling the bibliography of works in public finance. The author assumes, however, full responsibility for the data furnished and for the interpretation given to them.

H. L. L.

Princeton, New Jersey.

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Public Finance

CHAPTER I

Meaning and Development of Public Finance

PUBLIC FINANCE DEFINED

PUBLIC FINANCE deals with the provision, custody, and disbursement of the resources needed for the conduct of public or governmental functions. The subject matter falls, accordingly, into three main divisions. These are: first, *public expenditures*, which represent the needs of the state, second, *public revenues*, which are the source of the funds that are expended in the conduct of the public business; and third, *financial administration*, which deals with the determination of expenditures and income, as well as with the collection, handling and disbursement of the public funds.

Like economics, to which it is closely related, public finance deals with the satisfaction of human wants. All economic effort is directed to this end. A classification of the forms of organizing and directing economic activity would be somewhat as follows:

- I. Individual effort
- II. Cooperative effort
 - A. Private organization, such as
 - 1. partnerships
 - 2. corporations
 - 3. cooperative societies
 - 4. various trade and labor associations
 - B. Public organization (i.e., government)
 - 1. federal
 - 2. state
 - 3. local

In this classification, government appears as one form of coöperative economic effort. Government is one of the many forms of social organization that have developed, historically, as men have sought to minimize the effort required to produce certain desired results. All of the other methods of human association into functional groups have been produced by the same motive. The reasons for an extension of the coöperative organization beyond the limits of the many private groups have been:

- 1. The emergence of needs affecting or involving all of the people rather than those of a particular group or segment.

2. The greater economy of effort in supplying these universal needs by a general or common organization.

This interpretation of the nature and *raison d'être* of government eliminates the mystery and incantation that have so often enshrouded the subject. The quality and usefulness of government, under this view, depend upon its capacity to exist and operate within the same economic facts and principles as are controlling in the case of individuals and private associations. History provides many instances of governments which were operated as if they were superior to the fundamental rules of the economic order and as if they could therefore disregard these rules, but the record is bare of any case of enduring survival by such means. No government is superior to, or immune from, the economic facts which condition the solvency and well-being of the individual. Any government can operate for a time in defiance of these facts, since it can temporarily sustain itself by consuming the wealth of the people.

The list of the common or universal service needs which have been undertaken by public or governmental action has varied widely. The central core of this list has always consisted of defense, internal order and security, and the administration of such code of justice as may have been provided. To this nucleus of general needs various other services have been added at one time or another. In some cases the individual citizens could have made their own provision for these needs, and they commonly did so prior to transfer of the service to public authority. The growth of technology, the increase of population and an intensified subdivision and specialization of labor have hastened the process of enlarging the sphere of governmental activities. Thus, the improvement and lighting of streets, police and fire protection, education, welfare and recreation have been added to this list during the last one hundred years.

There is a disposition today to lean more and more heavily on government. In a certain respect this is made necessary by the growth of population and its congestion in great urban areas, and the increasing complexity of social life. The interests of public health, safety, and morals may demand an expansion of public authority and activity as conditions change. Within limits there is a genuine economy of effort in the relegation of these and other functions to the government. From another point of view, however, the habit of excessive reliance upon government may prove demoralizing. Individual initiative and enterprise do not prosper in an atmosphere of excessive paternalism, and the fundamental problem of governmental control and support is to strike the happy medium of promoting the general good without diminishing too greatly the individual's inclination and ability to solve his own difficulties.

It is unnecessary to attempt here to judge finally of the things which government ought, or ought not, to undertake. The student of public

finance is concerned rather with the facts of public activity than with the philosophy of the state and the theories of the scope of governmental functions. The tendency to expand these functions becomes significant, however, because they all cost money. As the facts regarding the cost of government and the course of public expenditures, taxation, and public debt are surveyed, it is impossible to avoid altogether the broader aspects of this tendency. The cost of government has been rising so rapidly of late years, the present burden is so great and the prospects for reduction are so remote, as to thrust the problems of public finance into the very forefront of current thought and discussion.

Public and private finance. The term *public finance* suggests that it stands in opposition to *private finance*, or to some other sort, and that it is only a part of the whole field. Unfortunately, the word *finance* has no generally accepted, definite meaning. It is evidently derived from the Latin *finis*, which means "end," "conclusion" of any matter, and hence "payment." Cohn reports that Grimm found no instance in German literature of the use of the German equivalent *Finanz* prior to the sixteenth century, and that its earliest connotation was the evil one of cheating and deceit.¹ This connotation was gradually dropped, and in the eighteenth century the term was narrowed in meaning to designate the revenues of the state.

Today the word *finance* signifies anything that has to do with money or money transactions. Thus, banks are spoken of as financial institutions, and any one with money to invest is called a *financier*. Another subdivision is *corporation finance*, which deals with the money affairs of business corporations. The securities market is commonly referred to as the financial market. In all these variants, the receipt, use or payment of money is a common element. The process of supplying the needs of the modern state involves the use of the money medium, so the expression *public finance* is in accord with the general usage. When the money economy came in, this term began to be used to designate the economic management of public bodies. It is not far removed in meaning from that which was originally conveyed by the term *political economy*. In its original sense, political economy was the art of managing the income and the outgo of the city-state in such manner as to make ends meet. The modern science of economics has been vastly broadened, although it still centers about the original idea of getting a living. The older art of state management or state economy was the forerunner of two modern sciences. One of these, political science, deals with the theory of the state and the practical application of these theories in the actual operation of government. The other, which is public finance, is the science of governmental financial management.²

¹ G. Cohn, *Science of Finance* (English translation by T. Veblen, 1895), p. 15.

² E. R. A. Seligman, *Principles of Economics* (1916), p. 7.

THE DEVELOPMENT OF PUBLIC FINANCE

The story of the development of public finance, if it were to be told in its entirety, would include, on the one hand, an account of the evolution of financial systems, and on the other a review of financial theories and principles. Either aspect of this story would occupy more space and involve more historical research than is demanded for the present purpose. The development of the subject will be briefly outlined by combining some elements from each side.

Public finance in ancient times. The curtain of ignorance which has for so long screened the remote past is being slowly lifted by the research of the archaeologist and by the interpretation of his findings. As this investigation proceeds, a surprising amount of information is being accumulated relative to the fiscal and other policies of the governments of antiquity. So far as is yet known, no systematic treatises were written on public finance for the guidance of the rulers and administrators of Egypt, Babylon, or Persia. Yet many of the materials essential to such a treatise were available in the practices and experiences of these ancient states. Professor Bullock has assembled some of these materials for various nations from the Egyptian kingdom of King Menes in 3,400 B.C. to the decline of Carthage in the second century B.C.³ A detailed study has been made of taxation in Egypt under Roman rule, covering approximately the period from 27 B.C. to A.D. 304.⁴ The Greek writer Xenophon wrote a treatise that has been preserved.

From these and other studies it is clear that the ancients knew much about various methods of taxation, and that they were familiar with currency devaluation as a device to lighten the payment of debt. They spent lavishly on temples, palaces, tombs, and other great public works. It is not possible in all cases to trace the decline of these ancient empires to the lavish spending on beautiful and impressive, but unproductive, monuments and memorials, although in some cases the connection is clear.⁵ After examining the record of four great kingdoms, Bullock concludes: ⁶

³ C. J. Bullock, *Politics, Finance and Consequences* (1939). He says that a modern work on public finance could well afford to reproduce and emphasize strongly Xenophon's observations concerning expenditures and general financial policy (p. 99).

⁴ S. L. Wallace, *Taxation in Egypt, from Augustus to Diocletian* (1937). The chapter headings of Professor Wallace's book indicate that many of the present-day taxes were used in Egypt by the Romans. There was a land tax, collected in kind from grain land and in money from vine and garden land. There were poll taxes, taxes on animals, on trades, industries and fishing, on the sales of various commodities, and on commerce into or through the country. At a much earlier time there had been a notable taxpayers' revolt, for so Professor Bullock describes the revolt of the ten tribes which split the Hebrew kingdom.

⁵ Cf. C. J. Bullock, "The Legacy of Rehoboam," in *Economic Essays* (1936), pp. 465-488.

⁶ *Politics, Finance and Consequences*, p. 49.

This narrow field of state activity is in marked contrast both with the earlier and with the later views as to the scope of state functions. Smith and the thinkers of the next generation who were deeply influenced by him represent the extreme movement of the pendulum of political thought in the direction of minimum state interference with individual affairs. Both Ricardo and Mill appear to take this narrow field of state functions for granted, and both omit all consideration of public expenditures, apparently on the assumption that these were static in scope if not entirely so in actual volume.

The defects of the laissez faire philosophy have long since been exposed. The nineteenth century was one of tremendous changes in the political as well as in the economic and social spheres. These changes and developments have had a most profound effect on the scope and character of the state's functions and activities, and they have naturally exerted a corresponding influence on the science of public finance. The subject has been organized in systematic form, its scope has broadened to cover all phases of state financial activity, and its importance is becoming greater as the burden of government increases. A summary of this growth of the subject is here unnecessary, for the remainder of the book is, in a sense, a review and restatement of the present status of its development. The discussion of practical measures will be limited chiefly to the experience of the central and local governments in the United States.

SCOPE OF THE SUBJECT

It is desirable, by way of concluding this introductory survey, to indicate the scope of the subject of public finance. Fundamentally, as Dalton insists, the main division is between public income and public expenditure.¹⁶ The state has need for certain income, and this need is met by the development of certain sources of revenue. Some writers, and especially those of the French school, have omitted public expenditures from their discussion. This is an arbitrary and illogical delimitation of the subject, for there can be no intelligent appraisal of the state's system for getting revenue without some idea of the volume of the state's needs and the relative importance of the various forms of proposed expenditure. Instead of omitting consideration of public expenditure, the present writer has given it priority in the order of treatment, thus signifying that it is one of the most important aspects of the whole subject. Part I, accordingly, deals with expenditure. In Part II are discussed those public revenues that are derived from sources other than taxation, while this most important of all the sources of public income is given separate treatment in Part III. The use of credit by a government is simply one of the ways by which income may be obtained, but it is more convenient

¹⁶ H. Dalton, *Principles of Public Finance* (1930), p. 5.

to deal with the special characteristics of public debts and the use of public credit as a distinct aspect of the subject, and this is done in Part IV.

A final section of the book, Part V, is devoted to financial administration. This is the control of the financial side of the administrative or operating services of government by the executive, under authorization of the legislature. It is exercised through the budget, supplemented by accounting, central purchasing, and other control devices. Broadly viewed, financial administration includes revenue administration also. It has proved more convenient, however, to discuss this phase of the general subject in connection with the different forms of taxation, since frequent reference must be made to the administrative structure and processes in the treatment of the taxes themselves.

PART I

Public Expenditures

CHAPTER II

Introduction: Definitions and Viewpoint

THE EXPENDITURES of government are a measure, in terms of money, of the services performed by the public agencies. The activities of government may be described in terms of the various services, such as protection to persons and property, education, welfare, and so on, or in terms of the amounts of money spent on these services.¹ A statistical summary of public expenditures is merely an objective statement of service activities in terms of money spent. Such a summary reveals nothing, of itself, as to whether the money has been well spent, or whether there has been extravagance, bad planning, an improper assignment of responsibility, or other factors that may have affected the total.

The traditional approach to the subject of public expenditures has been based on the assumption that government's primary objective in providing services through the expenditure of money is to be as prudent as possible in that spending, because it is acting simply as an agent for the people. As a form of social organization, established to serve certain common needs which can be handled better by this form of joint action, the obligation upon government to conserve the funds and assets committed to it is obvious. Under this view, government is not spending its own money, for it has none. It is spending the people's money, raised mainly through taxation. Prudence and economy are therefore required, in order that as little as possible of the people's money be taken for the accomplishment of the purposes required of government.

In contrast to this traditional concept of the rôle of government finance is the view that public spending should be regarded as a means of regulating and controlling the levels of prices and incomes within the national economy. This view has developed from the realization that the machinery and institutions for the creation of credit are capable of providing enormous quantities of spendable funds, and from the very practical political discovery that funds so created enable government to dispense, for a considerable period, with burdensome or politically objectionable taxes. Under this doctrine, it is said to be a duty of govern-

¹ In Chapter III, on the classification of public expenditures, various methods of arrangement are described, each designed to reveal a particular aspect of the government's activity.

ment to use its fiscal powers to provide, through the contraction or expansion of expenditures, a partial offset for the rise or fall of the national income. *Public investment, deficit financing, net income-producing expenditures, an unbalanced budget*—each of these terms indicates, in its own way, the method of the modern spending doctrine. While the theory of regulation which this doctrine embodies calls for contraction as well as expansion of spending, the practical result is that the time is never suitable for curtailment. In consequence, a nation that has committed itself to the policy of spending for the purpose of creating, thereby, enough prosperity to warrant cessation of the spending never gets to the top of the hill. It is a process of steady and continuous inflation.

Obviously, under such a doctrine, the emphasis is completely shifted from the old canons of prudence, economy, the importance of the services performed by government, and the willingness of the people to endure the necessary taxes. If liberal spending, per se, is a good thing, then the purposes for which the money is spent, or the amount of value received from the expenditure, become of secondary importance. Even wholly unnecessary purposes and services may be included, since the objective is to create incomes or purchasing power in the hands of certain groups rather than to do those things essential to the common good which can be done better by government than by individual or group action.

Lavish public spending is not a new, but a very old, idea. King Menes had this idea on the banks of the Nile more than 5,000 years ago. Solomon gave it a thorough trial, as did Nebuchadnezzar and Pericles. Louis XIV tried it. Mussolini and Hitler used it. The spending doctrine acquired great vogue in the United States after 1933, and it was defended, both on practical grounds and by the logic of some of the academicians.

The despotic lavish spenders of antiquity did not need to concern themselves particularly over popular approval. The modern lavish spender must take public opinion into account. Even in the dictator states, the great emphasis upon propaganda is eloquent testimony to the importance of preserving a desirable state of public opinion. In the so-called democratic countries, the spending policy must cater to the popular attitude, even while it is a powerful factor in determining that attitude.

The idea which underlies the spending philosophy, namely, a continuous inflation, is not new even in this country. Reduced to its fundamentals, it is nothing more than the use of an abundant supply of cheap money to induce a temporary and artificial prosperity. To go no farther back than 100 years, this idea was expressed in different periods as "wild cat banking," "Greenbackism," and "Free silver." The current form of the old, familiar panacea is cheap bank credit. Whatever the form, the underlying error is the same, namely, a belief that the circulation of

money rather than the production of goods is the important thing, and that in some way living standards will be raised and kept high if there be enough money and if it circulates enough. It is a case of inflation versus production.

This is not to deny that money is essential in a money economy. But its importance lies in its lubricating quality. It facilitates trading and exchanging and hence it promotes the growth of production, but in itself it is in no sense wealth. Its function in the modern economy is much like the function of oil in a motor engine. The engine will not run without it, but the oil is not the engine, nor does the oil really make the engine run.

The position taken in this book is that these newfangled versions of old theories of spending and inflating and financing government have in no way invalidated the accepted canons and principles of public expenditure and of the proper scope of government action. The enormous expenditures that have been made under the influence of this latest version of the cheap money doctrine should be judged in the light of a standard of prudence and economy in public affairs.

THE NATURE OF PUBLIC EXPENDITURES

The subject of *public* expenditures, as distinguished from the *private* expenditures of the ruling class, had comparatively little importance in the days when the ruling classes thought of their right to govern as something that had been conferred upon them by a special dispensation, and of the territories over which they ruled as simply a part of their private possessions. There was an element of truth in the latter assumption, for in the medieval period the chieftain who held the largest landed estates was usually the supreme ruler. In fact, it was by virtue of his possessions that he was the ruler. William the Conqueror acquired title to the lands of England by reason of his position as commander and leader of the invading forces. His claim was valid since no one had the power to dispute it successfully, and he used this land to reward those who had served him. Although he gave large tracts to his followers, he remained the largest single land holder in England. He was entitled to receive certain feudal dues and services from those knights and nobles who had received land grants under the feudal system of land tenure.

The Conqueror did not distinguish, however, between his public status as sovereign and his private status as owner of a large estate, nor was this distinction fully established in England for several centuries after the Norman Conquest. There was no public to be served in that earlier time, at least none which could make its needs felt, and the public duties of the sovereign merged insensibly with the private duties of the landlord. At a much later time the cameralist writers placed the revenue

from the king's domain first in importance, and they hardly emphasized at all the distinction between public and private expenditures.

The differentiation of the status of the sovereign as public head of the state from that of the person who, as head of the state, may also have his own private possessions, came only gradually and with great travail; but with it came the distinction between the obligations that devolved upon the ruler in his capacity as a public official, and those that were merely incident to the ruler as an individual. The governor, president or king of today may, as an individual, possess a large estate, but it is no longer thought of as a source of *public* revenue. The expenditures which public officials may make out of the income from their own property are clearly distinct from the expenditures which may be made by them or under their direction for the general public services. *Public* expenditures are those disbursements that are made for the general or public services of government, and they achieve importance *pari passu* with the conception of government as a form of social organization that exists to serve certain common or joint needs of men.² *Public* funds are contributed by the people, and they are spent, in theory at least, for public purposes and under public control.

SCOPE OF STATE FUNCTIONS

The volume of public needs, and hence the volume of public expenditures, will depend upon the scope of the powers and duties which the state possesses and exercises. Two schools of thought may be distinguished here. The first, whose doctrines found expression in the Roman law and in modern German political theory, makes the state the center. This viewpoint promotes and encourages the extension of state activities. In its extreme form the state becomes superior to all restraints and limitations upon its conduct, its methods, or its purposes, and is considered to be no longer bound even by the ordinary rules of morality and justice. Its decisions and actions become, in themselves, an absolute standard of public morality. Whatever the state does is right.

Absolutism was the keynote of the various dictatorships which emerged after the first World War. In each case, power was seized and ruthlessly held by an individual or a small group. A false front of ideological "window-dressing" was usually set up, but in no instance has there been

² There is one public office in the United States in which a man is actually compelled to pay a part of his official expense. This is the post of ambassador of the United States to certain foreign countries, which, for the reason given, is ordinarily not open to any but men of wealth. The social standards of foreign courts inevitably impose a financial burden on the diplomats assigned to them for which the regular salary and allowances of the office are quite inadequate, and those who accept such appointments are expected and permitted to pay no small part of the expense from their own resources. This practice may account in part for the frequent changes in the higher diplomatic personnel.

unswerving devotion to a principle. No dictatorship, however benevolent its professed intentions, can be consistent with the welfare of the people, for freedom is an indispensable element of well-being.

The other school of thought regarding the scope of state functions would exalt the individual and minimize the state. This is the doctrine of individualism, which found expression in English political theory and practice during the early nineteenth century. Although England has now moved a long way from this extreme position, the rights and the importance of the individual are still the central features of English political theory.

From the standpoint of the democratic state, the truth as to the proper scope of governmental functions lies somewhere between the extremes. The state's functions should not be insignificant, nor should they be all-embracing. They should aim at the promotion of the general well-being by the establishment and maintenance of those conditions under which the citizens will most assuredly prosper. A useful parallel may be drawn between the functions of government, under this conception, and the functions of a good traffic officer on the modern highway. The objective of traffic regulation is to expedite the flow of traffic along the highway in the greatest degree consistent with the rights and the safety of all travelers. Extreme *laissez faire* on the modern highway, which would involve the absence of all signals, warning and caution signs, and all traffic officers, would lead to chaos. Equally so, an excess of traffic lights, stop signs, improper speed limits and grouchy traffic police, would paralyze the traffic as effectively as the *laissez faire* attitude. The ideal condition is the provision of enough regulation to assure maximum movement with maximum safety.

Under the "traffic officer" theory of governmental functions, there would be neither an absence nor an excess of governmental regulation. The government would exist and operate in order to stimulate and serve the economic activities of the people, just as the traffic officer is provided in order to assist the safe movement of the traffic. The trend toward more governmental power assumes that government is superior to the people, and that they exist for its advantage and pleasure. This is no more true than to say that the traffic exists in order to support the traffic officer. The final test of all governmental regulation, and of all other governmental service, should be whether or not it leads to greater economic activity and productivity, and through increased production to steady advance toward a higher living standard. In other words, there is a limit to what the state can do, or should undertake to do. Put in ordinary language, it becomes a question of what the people, collectively, can afford.

The sane limit on state activity is reached when the value of the final installments of public services balances the economic cost of providing

them, as measured by the tax burden. This proposition is easily seen in an extreme case, but its general validity is not so readily perceived. For example, enormous armament expenditure clearly imposes severe economic strain. Despite the fact that these expenditures provide employment and create purchasing power for a time, they decrease the national resources and depress living standards. The explanation is that excessive devotion of the nation's economic resources to such purposes is a process of using up more than is put back. Under the circumstances, the government spending does not add as much to the national wealth and productive power as is consumed in the process. In a literal sense the nations cannot afford what they have been doing in the building of armament. The world's economic troubles after 1918 were a result of the tremendous destruction of men and resources during the preceding four years of war. Its political troubles have been a product of its economic troubles. The more recent wars throughout the world greatly increased the economic destruction, and they have therefore magnified the political difficulties of the post-war period. Unless mankind can find a formula on which to end the destruction of war, it will have demonstrated its incapacity to survive except at the cave-man level. The essential spirit of democracy is the only feasible basis of such a formula.

It is not so easy to see that a country like the United States, with a large territory, vigorous population, abundant resources, and free institutions, can be committed to peace-time projects and programs which cannot be afforded, quite as truly as is the case with a large armament program. Public expenditures that do not result in creating wealth or productive capacity at least equal to that consumed by the taxes levied, are injurious. They do more harm than good, eventually, despite the humanitarian purpose.

The economic limits to state activity. The question of economic limits depends on whether the state, as a political structure, is apart from and dependent upon the economic community, or is merged with the economic organization under some form of totalitarianism. The economic limits to state activity are obviously much more secure in the first case than in the second. That is, a state which must depend for its own resources on what the citizens can provide and still maintain, under private management and control, the economic activities out of which government as well as the people are supported, must not take so much as to impair the capacity of the people to keep on producing and paying taxes. On the other hand, the totalitarian state can command all the resources of its people by depriving them entirely of the fruits of their production except bare subsistence, by reducing everyone to the status of bondsmen or slaves. Under such a state, force replaces all other incentives; for morale is substituted the lash, the concentration camp and the firing squad; and for production is substituted military conquest.

Since the American people have fought against dictatorship and hope to escape becoming engulfed in any form of totalitarianism, the problem of the economic limits to state activity should be faced here on the assumption that normally there will be a system of free private enterprise, including the freedom to reject programs of state services or activities which involve burdens greater than the people are willing to bear.

From this point of view it is clear that the only sound policy of statecraft is to promote production. Both the people and the government must be supported from current production. This is driven home during a war, but it is as valid in peace as in war. It is overlooked by the advocates of schemes for sharing, since they usually assume that large production is automatic and inevitable and that whatever liberties may be taken with the apportionment of the product can have no effect on that production.

The economics of so-called social security provides a case in point. The aged—and the immature—as well as the workers, must be supported out of current production. A portion of the current product must be diverted from those actually engaged in its production to support these other groups. If this diversion is not to involve a corresponding diminution of the scale of living of the working group, production must be increased. The more that is done, or the more that is promised, for old age benefits and other aids, the greater must be the productive effort and the productive output if these plans are not to involve shrinkage in other shares of the product.

THE INCREASE OF EXPENDITURES

The trend of governmental costs has not required the impetus of peculiar or extravagant theories of public spending in order to reveal a strong and steady increase.³ This phenomenon has been manifest for centuries, and it has attracted the attention of many writers who have attempted to formulate laws of public expenditure in explanation of it. Adolph Wagner, a German authority on public finance, proposed a "law of increasing state activities," in which he postulated both an intensive and an extensive increase of state activities and functions.⁴ New duties are being constantly undertaken, he held, while the old ones are as constantly being performed on a more elaborate scale. Public expenditure tends therefore steadily to increase. Adams spoke of the tendencies toward increase or decrease of the different branches of expenditure as "laws"; and he presented in conclusion a "general law of expenditure for progressive peoples":⁵

³ Cf. F. S. Nitti, *Principes de science finances* (1928), pp. 59-88.

⁴ A. Wagner, *Grundlegung der politischen Oekonomie* (1892), p. 893.

⁵ H. C. Adams, *Finance*, Part I, Book I, Ch. II, especially p. 82.

Public expenditures tend constantly to increase, but this tendency does not apply in like manner to all governmental functions. Expenditures for protection exhibit a tendency to decrease in proportion as the protective service of the State succeeds; expenditures for developmental functions tend constantly to increase.

The last proposition has without doubt been sustained by the facts. That relative to expenditure for protection is correct in the abstract, on the theory that the object of protective expenditure is to protect. So naive a statement of the function of armament outlay is too simple, however, to explain the mad race for military, naval, aircraft, and now, atomic energy supremacy. Those expenditures which Adams would have classed as protective have increased with even greater rapidity than some of the so-called developmental expenditures.

Moreover, this tendency toward a constantly higher level of public expenditures has been well-nigh universal. It has occurred in poor as well as in wealthy countries: in those with a liberal, democratic government and in others which have retained autocratic or even despotic types. One German writer, Cohn, attributes the increased range of public expenditures in modern times to the progress of technical efficiency and the spread of democratic ideas.⁶ The Industrial Revolution effected a profound transformation of the economic and social life of those nations in which this series of changes occurred. Improvements in the technique of producing wealth resulted in an accelerating accumulation of capital, and in an ever greater productive capacity. The tendency for each nation to utilize its technical knowledge and equipment for war purposes forced all nations of the Western world to engage in a rivalry for supremacy in military and naval display and preparation that destroyed some of them and well-nigh bankrupted others.

The growth of democratic ideas paralleled for a time the development of industrial technique. Doctrines of universal equality spread rapidly and under their influence governments were forced to accept responsibility for a wide range of new duties and functions, such as public education, public health and sanitation, the care of defectives and dependents, the public control of industrial and commercial operations and conditions in the interest of laborers and consumers—in short, the amelioration of social ills generally. The democratic spirit, especially vigorous during the nineteenth century, elevated materially the standards of public living.

The emergence of dictatorships after the first World War checked the growth of democracy, but it did not result in smaller public expenditures. On the contrary, the totalitarian states went to even greater lengths in public spending than the democracies. Their major concern was armament and they subordinated all other aspects of national life to this

⁶ G. Cohn, *op. cit.*, pp. 74, 75.

objective. That the only outcome of unrestrained armament construction is war was again demonstrated in 1939.

Cohn's analysis must be supplemented by adding the influence of a third force—imitation—for, as suggested above, public expenditures have increased in some countries in which the progress both of industrial technique and of democratic principles has been slow. These countries, backward politically and undeveloped industrially, have imitated more progressive peoples, at least insofar as concerns the implements and paraphernalia of warfare. Cannon, gunboats, and airplanes they must have, even if schools and sanitation be lacking. In some cases the rulers learned the trick of public credit, and while this resource lasted they were able to indulge in wild orgies of extravagance.

THE PUBLIC AND THE PRIVATE ECONOMY

It is customary for writers on public finance to emphasize the differences between the public and the private economy, yet there may be legitimate doubt whether the differences are more significant than the similarities. Certain characteristics of government and its aims do appear to set the public economy apart.⁷ For example, it may be pointed out that the public economy is endowed with vast power under the legal concept of sovereignty, and it is able, therefore, to enforce its will against any individual or group. The internal limits on the public powers are set only by such constitutional restrictions as may exist, and by the available economic resources.

Further, the purposes or ends of the state, such as peace, education, security, health and welfare, are immaterial. They do not always or usually result in tangible, measurable products. These governmental services are not for sale, in the ordinary sense. Their total value cannot be added up, as can be done in the case of the goods and services privately produced.

Finally, in promoting the general good, the state may take a longer period into account than individuals can afford to do, since it is not required in its operation to apply standards of profitableness in the ordinary way. In the private economy, the profit test is controlling. While an assured profit is not required to motivate the individual, there must be some prospect of a return, and as this prospect diminishes, the amount or the margin of profit reward in the event of success must correspondingly increase. The state, it is said, does not seek a profit and need not restrict its activities to those which offer a prospect of pecuniary return.

Despite these differences in powers, methods, and purposes between

⁷ Cf. the discussion of these characteristics in C. F. Bastable, *Public Finance*, pp. 42-46.

the government, on one hand, and its individual citizens on the other, there are significant similarities between the public and the private economy. It is important not to overlook these similarities, for they may be of greater value than the differences in shaping a sound public policy. The following points of resemblance are fairly obvious:

1. The public economy, like the private economy, involves the use of labor and capital to accomplish certain results. The mystery, symbolism, and all the paraphernalia of pomp and power that have screened the essence of government from the common gaze have tended to create the impression that a government exists and operates, not only on a different plane from the individual, but in a different world, a world in which there is no application of either the physical or the economic principles that affect individuals. Sometimes it is held that even the fundamental individual morality of honesty, good faith, and humane conduct is not applicable.

All this is sheer humbug. In reality, government is nothing more than a device for using labor and capital to get certain things done. The workers in trade and industry are producing certain goods and services required by the people. Public officers and employees are no more than another set of workers, engaged in producing other services—and to a limited extent, goods—that are also required by the people. The government's services, in the aggregate, are more important than the services of any group of private workers, but they are not more important than the aggregate of the private services. In fact, government is dependent upon, and in a real sense is therefore secondary to, the whole of the private economic activity. While there could be some private economic activity without government, it is inconceivable that there could be government without the economic operations of private individuals by which government is sustained. Even under a communist régime, in which the government is the sole proprietor, employer and manager, the real power of the state is dependent upon, and conditioned by, the productive capacity of its people as individuals.

2. Both the public and the private economies are subject to certain fundamental economic principles. Each must respect the principle of the conservation of assets or wealth. Each is obliged to reckon with the fundamentals of economic cost. If this were not true, there would be no need of establishing public salary scales, and any public employee could be invited, with impunity, to name his own salary figure. Each must therefore aim at the creation of values at least equivalent to those other values, expressed as costs, which are consumed in the productive process.

3. Therefore, while government may be striving for ends which are largely immaterial and intangible, it cannot escape the obligation to shape its course, and arrange the purposes as well as the volume of its expendi-

ture, with a view to keeping the cost within the values created. It is not sufficient to say that intangible results are not commensurable with tangible costs. There is, after all, a test by which to determine whether the government's activities in the creation of intangible values are on a level that the nation can afford or are beyond that level. This test is the maintenance, if not the advance, of the general well-being. If the community can carry the governmental load and continue to prosper, then it can afford the luxury of such a load. If, under the burden of taxation or inflation imposed, the community standard of living is slipping toward a lower level, no further proof is needed that the government, in imposing those taxes or engaging in continuous inflation, is consuming resources in excess of the value of the intangible services provided in return.

CHAPTER III

The Classification of Public Expenditures

THE CLASSIFICATION of public expenditures means an arrangement of the data relative to governmental activities in such form as will clearly reveal the essential facts regarding the nature and cost of these activities. Public expenditure is the equivalent, in money, of the government services, consequently a classification of expenditure really means a classification of the things that government does. Thus, it is possible to speak of spending certain sums, or of performing services such as protection, health, education, and the like. Expenditure classification always leads to dollars and cents, but the things classified are the services and activities of government from various points of view. It would be possible to exaggerate the importance of classification. Substance is always more important than formal arrangement, and the details of classification must not be carried so far as to obscure the fundamental significance of the facts classified. Within limits, however, it becomes possible in this manner to give the public expenditures greater meaning and significance than they would otherwise possess. This chapter will be devoted to some of the factors involved in the problem of classifying the public expenditures.

PURPOSES OF EXPENDITURE CLASSIFICATION

Reveal proper financial relationships. The most important purpose to be served by a sound system of classification is that of securing a proper balance or relation among the different interests and activities for which the state has assumed financial responsibility. A proper regard for sound accounting methods alone would demand at least a working arrangement according to the purposes or objects for which the public money was being spent. But the accountant's system of classification would ordinarily be flexible enough to be adapted to any rough-and-ready method of recording appropriations and disbursements, if accounting ends only were to be served. The accountant would feel obliged to devise a system that would fit the facts as these were determined by the legislature, and he would therefore follow the legislature rather than lead the way by taking the initiative in setting up a proper classification. Every legislative action necessitates corresponding accounting procedure,

and the sum of the legislative appropriation acts determines the form and the scope of the accountant's record of the results.

Accounting and auditing officers are frequently concerned chiefly with the appropriations to the different funds, and their system of compiling records is therefore likely to be one that will indicate simply the condition of the several funds as well as to ensure that amounts expended are properly charged to the funds against which the warrants are drawn.

This is an important public service, for it is extremely necessary that suitable legal safeguards be maintained about the collection and disbursement of public funds. A system of accounting and auditing could be devised that would accomplish these purposes without providing at all for a proper classification of public expenditures. Evidence of this is to be found in the financial history of any state or municipality in the United States. The money in the treasury may be properly and accurately accounted for by the treasurer, the warrants drawn by the disbursing officers may be carefully examined by the auditor, and the payments may be credited to the fund which is responsible for supplying the different services. Under such a system it is true that the public funds are legally expended and adequately safeguarded. More than this must be done, however, if the real significance of the public expenditures is to be appreciated by those who bear the burden. Standards of classification must be provided which will be at once logical and practical, in order that both legislators and private citizens may ascertain the character and the relative importance of the activities in which the state is engaged.

Promote interest in public finance. Statistics are seldom interesting, as such, and accounting is a closed book to many people. The information contained in official reports can be given vitality and meaning only if it is arranged in a way that will reveal, simply and clearly, the operations and activities of government. One important aim of a system of classification should be to give greater reality to the business of government, and thus to stimulate the interest of the people in public affairs.

Aid budget procedure. A sound classification of expenditures is essential also to the success of modern budgetary procedure. Wise use of public funds depends upon careful consideration of the relative importance and needs of the various departments or divisions of the governmental organization. The fundamental idea of the budget is that each department or division of activity shall be appraised and an appropriation made for its support, the amount of which shall be determined by taking into account the importance of this particular activity, and the total of the public requirements. Without a classification of public expenditures from which such a comparison can be accurately and speedily made, the actual appropriations may display a serious error in emphasis. Some services will be supported in luxury while others are starved.

Further, adherence to a reasonable, uniform classification of expendi-

tures over a period of years would provide a mass of financial data that would be vastly more useful in comparative studies of the cost of government than are any figures of governmental cost now available. The United States Census Bureau expends an immense amount of energy, working through the financial statistics of the American states and cities in order to present these materials in consistent and comparable form. Some years ago the Wisconsin Tax Commission was instructed to compile comparative financial statistics of the various local subdivisions of the state, counties, cities and towns. It proved to be impossible to carry out these instructions without first installing a uniform system of accounting, that is, a uniform classification of expenditures. The conditions that were discovered in the commission's preliminary studies led to the enactment of legislation to secure this result.

Uniform accounting systems for local subdivisions have been established in a number of states, usually under the direction and control of the state tax commission or some other central administrative authority. One of the principal objects sought in the enactment of uniform accounting legislation, thus far, has been the provision of adequate checks upon the handling and use of public funds. Such legislation constitutes the ground work for a more thorough and accurate audit of the financial transactions of local officials. In practically every state in which such improvements have been introduced, numerous cases of irregularity in the handling of funds have been discovered, and some instances of embezzlement and misuse. Central control of the accounting forms and audit of the resulting records will end these irregularities and stop the leaks. If the accounting system is worked out with the broader ends of a proper classification in view, it may be made to contribute, in a significant way, to these larger purposes. Distinct progress in this direction has been achieved by some states, although it is yet a long way to the goal of a uniform classification of public expenditures that will permit intelligent comparison of the cost of government among different states, or even within the same state over a period of time.¹

VARIOUS METHODS OF CLASSIFICATION

The viewpoint of political philosophy. The classification of public expenditures may be undertaken from different points of view, and

¹ A. E. Buck presents model forms suitable for introducing a standard uniform classification of expenditures, *Budget-making* (1921) and *Public Budgeting* (1929). Cf. the comments made by the Minnesota Tax Commission on the difficulties encountered in making a comparative study of the cost of government in certain neighboring states, in its *Report* (1916), pp. 189-228. See also the Connecticut Tax Commissioner's criticism of the local officials' methods of recording their financial business, especially their financial records, in *Quadrennial Statement of Local Indebtedness*, etc. (1936).

different writers have employed diverse methods. Unfortunately, there is as yet no general agreement as to the proper system of classification, and it is entirely possible that more than one method will prove to possess the fundamental requisites of logical unity and practicability. Bastable presents a system which rests in part on the order of historical development of the various branches of expenditure, and in part upon the author's conception of the state's functions.² The result is logical enough, but the method of approach is not always sufficiently accurate in its emphasis. The earlier public functions to appear, aside from that of defense, are not necessarily those of greatest importance for the modern state. Nitti presents a functional classification similar in general to that used by Bastable.³ Professor H. C. Adams has also taken into account the functions of government, which he groups under three heads: protective, commercial and developmental. This arrangement is not entirely satisfactory, since the line between these groups must at times be arbitrarily drawn, and the basis of the classification is not always clear. For example, he regards social sanitation (whatever this may be understood to include) as a protective expenditure, while recreation is classed under the developmental expenditures. Cohn suggests that the degree of benefit conferred upon the citizen by the expenditure be taken as the basis of classification. This suggestion is accepted and followed by Plehn. It is not always easy, however, to determine the degree of benefit conferred, and in any case this benefit may vary widely with different classes of citizens. A further feature of this plan is the use of the benefit conferred as a means of determining whether the individual shall receive the state's service without charge, at cost, or at a price which shall net the government a profit. A service that is of benefit to the individual citizen shall be paid for only by him; and in proportion as the benefit approaches universal diffusion, the charge to the individual shall be reduced, and finally entirely eliminated.

The principal difficulty here is that the distinction between special and common benefits is not stable. The same service may shift from one side of the line to the other as social evolution proceeds. Historical comparison of expenditures is thus rendered difficult. Further, the government does not always distinguish carefully the actual proportion of special as compared with common benefit. That is, a special benefit to some may be treated as if it were a common benefit to all, and vice versa.

Shirras suggests, as the ideal classification, a twofold grouping of public expenditures—primary expenditure and secondary expenditure. Primary expenditure would include that made for the basic purposes of all government, namely, defense, law and order, civil administration and the payment of debts. Secondary expenditure would be that applied to

² C. F. Bastable, *Public Finance*, Book I.

³ F. S. Nitti, *Principes de science des finances* (1928), pp. 131-142.

the useful but less essential activities of government, such as promotion of the social welfare through education, public health and charitable relief; the conduct of public undertakings such as water systems and similar enterprises; and various miscellaneous expenditures.⁴

A PRACTICAL WORKING CLASSIFICATION

Expenditure classifications such as the foregoing aim at some logical organization of governmental operations, based on the several authors' respective conceptions of the philosophy of government. They may serve this purpose, but they are not sufficiently concrete to serve as a working basis for the explanation of governmental costs in terms that can be understood by the average citizen. For this practical purpose the following grouping of the main expenditure headings is suggested.

1. Ordinary Governmental Activities
 - a. Current operation and maintenance
 - b. Capital outlays
2. Commercial Enterprises
 - a. Current operation and maintenance
 - b. Capital outlays
3. Interest
 - a. General governmental debt
 - b. Commercial enterprise debt
4. Trust and other Special Funds
5. Bookkeeping transactions

In this arrangement, the first group, *Ordinary Governmental Activities*, embraces all of the services that government performs for the people except those in which a commodity or service is supplied through a commercial or business undertaking. Protection, education, health, sanitation, and recreation are illustrative of this type of service. Under the second group, *Commercial Enterprises*, are found the various undertakings such as water supply, electric energy, transit facilities, the postal service, markets, and the like. With respect to each of these main divisions, the distinction between the expenditures for current operation and maintenance and those for capital extensions and improvements, or *Capital outlay*, is important. Some difference of opinion may exist as to whether or not both the capital outlays and the payments for debt redemption should be shown. In a sense this practice would involve duplication, for the outlay means expenditure of the funds at the time they are borrowed (assuming an outlay to be financed by means of a loan), whereas the payment for redemption of the debt is made at some later time. To preserve strict consistency over a period of years, one or the other item only should be set up as an actual expenditure, and it seems reasonable

⁴ G. F. Shirras, *The Science of Public Finance* (1925), pp. 50-52.

to use the outlays rather than the debt payments for this purpose. Debt redemption must be recognized, of course, as an important factor in the tax burden, but the expenditure represented by the debt was in reality made earlier, at the time the money was borrowed and the improvement was made.

The expenditure from trust or other special funds must ordinarily be segregated under the terms of acquisition of such funds, although it may be applied to any of the services of government. Thus, many states have substantial investments representing the proceeds of the sale of school lands, and this revenue is spent for education. Other funds represent the accumulations toward employee retirement pensions, while still others have been contributed by individuals for the support of museums, art galleries and similar purposes. A comprehensive expenditure classification would indicate the purposes, such as education, recreation, pensions, and the like, to which the income from trust and other special funds is devoted.

Bookkeeping transactions are those in which the reporting governmental unit transfers money from one purpose to another, or in which it acts merely as an agent for another unit. All such operations must be identified and segregated in arriving at a correct statement of the governmental costs of the reporting unit.

The Census Bureau classification. The United States Census Bureau has done more than any other agency in this country to develop a thoroughgoing classification of public expenditures. The results of the bureau's efforts are presented in two series of publications, one on the *Financial Statistics of States*, and the other on the *Financial Statistics of Cities*.⁵

The Census Bureau's classification of expenditures may be outlined as follows:

A. Governmental Cost Payments

- 1. Expenditures for current operation and maintenance of general departments.⁶**
 - a. General Government*
 - b. Protection to Life and Property*
 - c. Health*
 - d. Sanitation*

⁵ United States Census Bureau: *Financial Statistics of States*, published annually since 1915. No volume was published for 1920, and that for 1921 is incomplete, owing to lack of cooperation of certain states. *Financial Statistics of Cities*, published annually since 1902. The first two reports included all cities of 25,000 population and over, but since the report for 1904 the minimum population limit has been 30,000. In 1932 the population limit was raised to 100,000. In 1942 this limit was dropped to 25,000, but the reports were materially abridged in scope.

⁶ This grouping of general departments is used for cities. For state governments, health and sanitation are combined, and a new department, "Development and Conservation of Natural Resources," is added.

- e. Highways
- f. Charities, Hospitals and Corrections
- g. Education
- h. Recreation
- i. Miscellaneous and General
- 2. Expenditures for current operation and maintenance of public service enterprises
- 3. Interest
- 4. Capital Outlays⁷
- B. Non-Governmental Cost Payments
 - 1. Cancellation of Debt Obligations
 - 2. Transfers
 - 3. Refunds
 - 4. Trust Funds, and others

The expression *Governmental Cost Payments* is defined to include

...the costs of the services employed, properties constructed, purchased, or rented, public improvements constructed or otherwise acquired, materials utilized, and interest on borrowed moneys, which are incurred for protecting person and property, and health, providing social necessities and conveniences, caring for the dependent and delinquent classes and carrying on other activities for which governments have authority.

Non-Governmental Cost Payments are defined as:

...amounts paid under such conditions that they do not result in a decrease in the value of governmental assets without decreasing indebtedness.⁸

The census classification provides substantial further detail under each of the so-called general departments. In some respects its arrangement may be questioned. Thus, the cost of the courts is reported under the first heading, *General Government*, whereas it would seem equally appropriate to regard court expenses as part of the cost of protection of life and property. Again, the cost of aid to certain special classes, such as mothers and veterans, is reported under miscellaneous expenditures, rather than under charities. Retirement pensions to policemen, firemen, teachers and other employees are likewise reported in the miscellaneous group, although a case could be made for reporting these costs under the social welfare group. The census method results also in a certain duplication as between the states and the cities, owing to the fact that it reports as a state expenditure state apportionments or grants to local units, and it also reports the total expenditure of local units from all sources including state grants. Such funds should be allocated, in a comprehensive resumé

⁷ The bureau segregates capital outlay expenditures according to the departmental grouping shown under A-1, and also according to the principal types of public service enterprise.

⁸ These definitions are usually repeated in each publication. Cf. for example, *Financial Statistics of Cities*, 1924, pp. 19, 44.

of state and local expenditures, to the local units which actually dispose of them, and they should be deducted from the state totals.

The Census Bureau's classification, which is here summarized, is the only available basis of reducing the vast and varied mass of items entering into the cost of state and local government to some kind of orderly and comparable arrangement, and great credit is due the bureau for the painstaking effort devoted to the collection and organization of these data. The irregularities and defects of local financial reporting require immense effort for the achievement of such results as have been produced, although there is a growing tendency for states and cities to set up their expenditure records in general conformity with the bureau's outline.

Other classification devices. The arrangement of the general departments of government, in this classification, is an attempted approximation of the important functions or service activities of state and local government. But there are other ways of classifying expenditures, each of which is useful in presenting the facts from different points of view. At least five such methods have been proposed.⁹ The first of these is the *functional* analysis, the object of which, when properly constructed, is to tell *what* the government is doing, that is, to set forth the nature of the activities and services undertaken by it.

A second method is to classify expenditures according to the *organization units*, that is, the departments, bureaus, divisions and institutions, which are actually spending the money. This method reveals *who* is doing certain things. It has the merit of fixing more definite responsibility for the actual disbursements upon the officials or organizations which make them, whereas the functional classification may not do this unless the governmental organization units are laid out on strictly functional lines.

A third method is classification by the *objects* of expenditure, by which is meant an analysis of the disbursements according to the objects actually purchased, such as fuel, labor services, insurance, and new equipment. It is clear that this method of presentation would shed light upon such important questions as the efficiency of government purchasing, personnel administration, and standards of property maintenance.

A fourth method would reveal the *character* of the expenditure by which it would be possible to distinguish between current expenses, fixed charges, acquisition of property, and debt payment. Finally, the classification might follow the *funds* that have been set up in the appropriation acts, and indicate the transactions which have taken place in each. As was indicated above, fund accounting has its legal justification, but when made the sole method of reporting public financial transactions, it inevitably enshrouds the whole matter in such a dense fog that the layman is totally unable to perceive, not to speak of following, the issue.

⁹ A. E. Buck, *Public Budgeting*, pp. 181 ff.

Each of these methods of keeping the financial records has its particular usefulness, and the most complete practice doubtless requires that all of them be observed.¹⁰ From the standpoint of popular judgment on public policy the functional arrangement is best, while from that of definite location of administrative responsibility for results, the classification by organization units is most satisfactory. If the administration is organized, and it should be so far as is possible, upon functional lines, these two important purposes are combined. No great burden will be imposed upon the accounting forces to carry the records of expenditure also according to objects and to character, once suitable forms for these purposes have been devised. The further details of this subject must be left to the special treatises, but it is desirable again to emphasize the importance of establishing some kind of clear, simple, and reasonably logical scheme of classifying the public expenditures in such manner as will afford the basis for a sound popular judgment of public policy, as well as for sound and intelligent criticism of the efficiency with which these policies are being carried out. The technique of expenditure control, outlined in Chapter VII, stresses the importance of expenditure analysis and indicates other possibilities for the use of such data in the formulation of policies.

¹⁰ F. Oakey, *Principles of Government Accounting and Reporting* (1921), Ch. XII.

CHAPTER IV

The Federal Expenditures

THE PURPOSE of this chapter is to present a brief, overall story of the federal expenditures and to use this record as the basis for such matters of principle and policy as may be pertinent.

The history of the federal expenditures falls into four fairly distinct periods: the first covers the years from the organization of the Union to the first World War; the second extends through that war and to the economic depression of 1929; the third includes the decade 1930-1939; and the fourth includes the second World War period from 1940 to 1945. The first period could logically be subdivided at the Civil War, but the impression gained from consideration of the whole record is that even this great event was of minor fiscal consequence by comparison with the financial operations of the present generation during both war and peace.

THE FEDERAL EXPENDITURES, 1792-1915

The deficiencies in the method of classifying and reporting the federal expenditures are at once apparent from an examination of Table I. The first column of this table, entitled *Civil and Miscellaneous*, includes the total expenditures for all purposes not separately shown elsewhere. That is, it includes the legislative, judicial and executive expenditures, and those for all federal departments except War, Navy and Post Office. The last-named department is involved only to the extent of deficiencies in the postal revenues. Since the form of the table antedates the Department of the Interior, the expenditures for Indian affairs and for military pensions are also given separately.

The increase in the civil expenditures from the beginning of the Union to the outbreak of the first World War was the natural and normal result of the growth of the country in territory and population. The rapid settlement of the West after 1820 compelled an extension of the land surveys and provision of courts and judiciary for the newly settled territory. The growth of foreign and domestic commerce made necessary the construction of lighthouses, customs buildings, and other public improvements.

In addition to this physical and material expansion of the country,

TABLE I

DISTRIBUTION OF THE FEDERAL EXPENDITURES BY MAJOR PURPOSES FOR CERTAIN YEARS *
(THOUSANDS OF DOLLARS)

Year	Civil & Miscellaneous	Postal Deficit	War Department	Navy Department	Indians	Pensions & Other Compensation for Military Service	Interest	Total
1792	654	.....	1,100	...	13	109	3,201	5,709
1800	1,337	.. .	2,561	3,449	...	64	3,374	10,786
1810	1,101	.....	2,294	1,654	177	84	2,845	8,157
1820	2,592	.....	2,630	4,388	315	3,208	5,216	18,261
1830	3,237	.....	4,767	3,239	622	1,363	1,914	15,143
1840	5,996	.....	7,097	6,113	2,332	2,604	175	24,318
1850	14,920	.....	9,400	7,905	1,606	1,870	3,782	39,543
1860	18,087	9,890	16,410	11,515	2,949	1,103	3,177	63,131
1870	64,389	4,895	57,656	21,780	3,408	28,340	129,235	309,674
1880	60,612	3,071	31,942	13,536	5,945	56,777	95,757	267,642
1890	106,595	6,875	32,820	22,006	6,708	106,937	36,099	318,041
1900	150,175	7,231	116,289	55,953	10,175	140,877	40,160	520,861
1910	200,606	8,495	160,797	123,173	18,504	160,696	21,342	693,617
1915	268,732	6,637	133,962	141,836	22,130	164,388	22,903	760,587
1919	2,995,791	344	9,219,981	2,009,272	34,593	576,420	615,867	15,452,268
1920	2,448,991	35,813	1,044,960	629,893	40,517	448,334	1,024,024	5,672,533
1925	573,641	23,217	267,878	326,365	38,755	769,705	882,373	2,881,934
1930	914,284	91,714	348,663	374,053	32,067	819,997	658,602	3,239,380

* The materials for this table are taken from the *Annual Report of the Secretary of the Treasury*. These data are presented in different versions in the several reports. To 1915 they are on the basis of warrants issued. For the subsequent years shown in the table the figures were taken from the annual table entitled "Comparison of Disbursements," based on warrants issued (net), with the total of expenditures adjusted to allow for unexpended balances.

The following further adjustments have been made:

1. Expenditures for the improvement of rivers and harbors, and for the maintenance and operation of the Panama Canal have been transferred from the War Department to the Civil and Miscellaneous Column.

2. All expenditures for or on behalf of veterans are included in the Pension Column.

3. The advances to foreign governments (and for farm loan purposes) in 1919 and 1920 have been omitted.

4. Beginning with 1921, the published table shows the amount of public debt retirement charged against ordinary receipts under the sinking fund act. Such payments were, \$466,538,000 in 1925, and \$553,884,000 in 1930. These amounts should be added for the years in question to obtain the total expenditures chargeable against ordinary receipts.

5. Refunds under customs and internal revenue laws are omitted since 1919.

and in some respects of even greater importance as a cause of increasing federal expenditures, has been the extension of federal administrative activities into additional fields. The calendar of the creation of federal administrative departments illustrates this extension. The national government began with four departments—State, Treasury, Army and Justice. The office of Postmaster General was established in 1789, but this official first sat as a member of the cabinet under President Jackson, and the department was officially recognized, rather tardily, as an executive department in 1874. The Navy Department was created in 1798, the Interior Department in 1849, the Department of Agriculture in 1862

(elevated to an executive department in 1889), the Department of Commerce and Labor in 1903, and the Department of Labor in 1913. Recently there has been agitation for a Department of Education and Public Welfare, and for a Department of Transportation and Communication.

Federal administrative activity prior to the first World War extended into fields not covered by the existing departments and various independent agencies were set up, so-called because they were not affiliated with a department. In 1910 there were four of these,¹ and by 1917 eleven more had been added.

This activity was extended also by the enactment of regulatory and developmental measures affecting many lines of private enterprise. The centralizing tendencies of the early years of the twentieth century produced such measures as the Pure Food and Drug Act, more stringent legislation for railroad regulation, reforestation, conservation and reclamation, trust control and supervision of the plane of business competition. It was natural and inevitable that the cost of the civil functions of the federal government should rise steadily under these conditions.

Military and naval expenditures. It is but natural that successive wars should produce expansion of the Army and Navy Departments. The navy received the bulk of the increase in the decade following the War of 1812, while the army was the recipient of the greater part of the increase following the Indian, Mexican, and Civil wars. In both cases the figures show a decided increase between 1890 and 1900. The bulk of this gain came with the Spanish War. The military and naval achievements in that contest were creditable enough, but the experience demonstrated the necessity of army reorganization, while the new responsibilities that were thrust upon the nation with regard to the future of Cuba, the Philippines and other insular interests, led to larger military and naval appropriations. By the end of the nineteenth century, too, European nations were busily engaged in demonstrating their theory that competitive armament building was the best way to ensure world peace. A mild infection of this doctrine was an important factor in the subsequent growth of the federal naval and military appropriations.

It is curious that in view of the cost of the modern battleship and the relatively small size of the regular army, the expenditures for the War Department should have been so consistently greater than those for the Navy Department. The popular impression, especially after 1890, was doubtless to the contrary, for there was much talk of a big navy before and after the Spanish War, but no one was especially concerned over an increase in the army. The expenditures for coast defenses are in the War Department budget, but considering the length of the coast line, the amount devoted to this purpose has never been large. Fortunately,

¹ The Alaskan Government, the National Museum, The Smithsonian Institution, and the Interstate Commerce Commission.

no occasion has ever arisen to warrant fortification of the two long land frontiers.

The reported cost of the War Department includes, also, expenditure for some non-military purposes. This department has administrative supervision over a number of activities quite unrelated to its primary business. The most important of these is the improvement of rivers and harbors. The War Department expenditures given in Table I do not include those for rivers and harbors since 1880, but they do include the other civil expenditures made under its jurisdiction. These miscellaneous civil items do not aggregate enough to invalidate the general comments on the development of the military expenditures for war purposes.

Indian affairs. This column presents the expenditures of the federal government in caring for the Indian wards of the nation, in the discharge of treaty obligations, and in other ways by which the well-being of the Indian tribes may be safeguarded. The amount involved has steadily increased, but the total has never been large; probably not as large at times as the well-being of these charges and the government's moral obligation have demanded.

Pensions. The story of the federal experience with military pensions has a significance for the student of public finance that is not accurately measured by the relative outlay for pensions in any annual budget.² This story is too long to be told here, and the present account will be limited to certain outstanding aspects of federal military pension policy.

In the first place, disability pensions have always been given to those who had been wounded, otherwise injured, or who were suffering from disease contracted in the service. The nation has always recognized this obligation and has always been willing to meet it, although the means provided whereby proper care was to be given the disabled have not always been adequate to the purpose, nor has their administration been at all times above reproach.

A second characteristic of federal pension experience has been the inevitable development, after every war, of pressure for service pensions to be given to all whose service record was clear, regardless of their physical or economic situation, and usually, without regard to the length of the service. Unfortunately, the zeal of some who have been interested in broadening the federal pension system has led to the use of improper, even of corrupt, means of accomplishing their purpose. The demoralizing effect of massed political influence, especially following the Civil War, induced Congress to relax progressively the terms and conditions on which pensions were to be granted. Disability pensions have been granted to Civil War veterans on parole evidence since 1879, and of course to many persons whose disability had no connection whatever with their war service. The military record of thousands of persons has been

² W. H. Glasson, *Federal Military Pensions in the United States* (1918).

"corrected," as Congress is pleased to style the process, in order to make them eligible for pensions. The administration of pension affairs at times has been such that hundreds of pension checks have been improperly issued in the names of deceased soldiers, to remarried widows of veterans, and in other improper ways.³

A third characteristic has been the well-nigh indefinite prolongation of pension legislation. The last Revolutionary War pensioner died in 1906, or 130 years after the beginning of that war; and in 1935 there were four pensioners of the War of 1812. On the basis of this experience, pension payments, on account of wars now over, will be made until near the end of the next century.

The result of these tendencies in pension practice has been a steady expansion of the pension expenditure. The early advocates of military pensions for Civil War service thought that the peak of cost would be reached by the end of the seventies, but as a matter of fact the program was hardly well started at that time, as the expansion following the Arrears Pension Act of 1879 showed. The maximum number of Civil War pensioners was 999,446 on June 30, 1902, but the subsequent extension of the pension privileges was such as to produce an enrollment of 820,200 on June 30, 1913, more than half a century after the conflict began.

Interest. The interest charges on the federal debt have varied greatly according to the amount of indebtedness outstanding and the rates of interest paid. The new federal government assumed the burden of the Revolutionary debt in accordance with Hamilton's plan for refunding, and throughout the first decade interest payments were one of the heaviest items of the governmental expense. Some reduction was effected by Gallatin but the new debt incurred in the War of 1812 brought an increase of 218 per cent in interest charges between 1812 and 1816. Thereafter the interest on public debt steadily and rapidly diminished to 1835, and, for the two years following no interest charge appears. The United States was out of debt.

The panic of 1837 caused a slump in the revenues and government borrowing was resumed. The volume of debt remained small until the Civil War, when it was greatly increased through the efforts of Secretary Chase to finance that conflict by the use of public credit. The maximum interest charge after the war was \$143,781,000, in 1867. By a series of refunding acts and a steady program of debt redemption the interest was rapidly reduced during the generation following the Civil War. Additional borrowing during the nineties increased the interest expense again, but another refunding act, in 1900, together with moderate redemption

³ Cf. details given by President Hoover in his veto of a private bill in 1932 (H. R. 9575, 72nd Congress). Quoted by G. A. Weber, and L. A. Schmekebieer, *The Veterans' Administration*. (1934), pp. 245-247.

during the following decade, cut the annual interest payment in half by 1910. In the meantime the Panama Canal bonds had been issued.

FIRST WORLD WAR AND POST-WAR PROSPERITY, 1915-1930

The second major period in the history of the federal expenditures embraces approximately fifteen years, from the beginning of the first World War early in the fiscal year 1914-1915 to the crisis phase of the economic cycle which appeared in the autumn of the fiscal year 1929-1930. This was a period of rapid and phenomenal economic, political, and financial change throughout the world. It witnessed the systematic and organized destruction of men and materials on the most extensive scale that had thus far been known in the history of the race, and the violent economic and political changes were a product of the efforts made to readjust to these terrific losses. It was as if a long accumulation of repressed savagery had finally burst through all restraints. The economic exhaustion produced by this conflict was a significant factor in producing the severe depression of the early 1930's.

Administrative expansion and contraction. The entrance of the United States into the first World War in April, 1917, made necessary an enormous expansion of the administrative departments. The unprecedented task to be handled compelled a rapid expansion, in the course of which there was, inevitably, waste and lost motion. The momentum of the war effort extended into the fiscal year 1919, when the peak was reached. Despite the cessation of hostilities in November, 1918, it will be noted that there was but moderate abatement of the total of the civil expenditures even in the fiscal year 1920.

All of the civil departments shared in the administrative expansion occasioned by the war, but in different degree. Some of the special war activities were handled by separate boards, commissions or bureaus which were set up for specific purposes. In a few cases the corporation device was employed. These special agencies spent \$1,135,000,000 in 1918, \$2,723,000,000 in 1919, and \$1,706,000,000 in 1920. The most costly of these special undertakings was the United States Shipping Board, and a large part of the abnormal increase in civil expenditures during the war years was due to the shipbuilding program directed by this board. The burden of war shipbuilding was greatly reduced by 1920, but in this fiscal year the federal railroad administration spent \$1,038,615,000, while the departments of agriculture and commerce spent much larger amounts than in any previous year of their history. The operation of the new and complicated revenue laws increased the expense of the Treasury Department, by 1920, to more than three times as much as for the year 1917. The rivers and harbors expenditure in 1920 was the largest thus far made in the history of this series. The record of the civil expenditures

indicates clearly that in the financial sense the war did not end with the Armistice. The administrative demobilization could not be completed until after that of the military forces. A flood of war materials, including everything from ships to shirts, continued to pour out, at war-time contract prices, until the contracts could be cancelled. Some of the ships rotted in the harbors where they were built; some of the trucks, guns, ammunition and other war materials were sold in Europe at bargain prices (but are not yet paid for); and some materials, notably clothing, small tools and the like, were sold to the people at nominal prices through special, temporary merchandising outlets.

During the 1920's the civil expenditures were reduced far below the abnormal peak of the war years, but at their lowest level the total completely eclipsed anything in the national experience prior to the war. The federal administrative organization was never demobilized to the pre-war basis, and the civil expenditure level through these years was sustained by this costly administrative structure and by the growth of federal grants to the states for highways and other purposes. The number of independent agencies had risen to more than forty, indicating looseness of organization and an absence of well-knit coördination within the departments.

The army and navy. Naturally, during the first World War, the army involved greater expense than did the navy. The latter had been expanding and training for twenty years, and so was more nearly ready to fight. The small regular army force had to be supplemented by a vast number of civilians who required to be assembled, housed, equipped, and trained in military lore and methods.

In connection with the efforts to establish a sound basis for world peace which characterized the early 1920's, a limitation on armament was agreed to in Washington in 1921. This agreement affected naval power only, and for a time it resulted in diminished expenditures on naval construction and in some destruction of certain classes of naval craft in excess of the stipulated limits. It was denounced by Japan in 1934, effective in 1936. After the collapse of naval limitation by international agreement, the only restriction upon naval increase was economic capacity. It is interesting to note, however, that notwithstanding the Washington agreement, the navy received larger support during the 1920's than did the army. This was a striking reversal of the earlier policy, for there had been only one year in the period from 1853 to 1920, in which the army did not have the larger appropriation.

Veterans' compensation. The term *compensation* does not refer, here, to the pay currently received by those in the military service, but to the pensions or payments in lieu of pensions. The War Risk Insurance Act, as amended in 1917, contained provision for compensation to the dependents of officers and men for disability or death resulting from the service.

Reasonable hospital, surgical, and medical allowances were also to be given. In addition to this type of protection, which was similar in principle to the earlier disability pension arrangements, the new law provided two other forms of compensation. The first was provision for the support of the families and dependents of enlisted men through a system of compulsory allotment from the pay of the men and family allowances contributed by the United States. The second feature was the privilege of securing insurance, ranging in amount from \$1,000 to \$10,000 as term insurance renewable year by year during the war, and convertible afterwards into various standard forms of insurance. The government carried the administrative costs and also the extra hazards due to the military operations in which the insured were engaged.

The practical result of the war risk insurance plan was to put the federal government into the insurance business on a large scale. The privilege of converting term into standard premium insurance was ended, in 1928, for those who were not then in good health. At the close of the fiscal year 1945, there were in force 569,934 United States Government life (converted) policies, representing \$2,495 millions of insurance. For this year the premium income was \$50,693,000, and a dividend reserve of \$9,060,000 had been established.

The life insurance legislation that had been developed for the veterans of the first World War was supplanted in 1940 by a new national life insurance program. Thereafter, all policies were to be issued under the terms of the new law. To June 30, 1945, 17,492,388 policies had been issued, representing \$135,021 millions of life insurance, or an average policy of \$7,719. On the above date the policies in force numbered 15,944,158, with total insurance amounting to \$123,580 million. All policies were issued under a 5-year level premium plan, and to remain in force they must be converted into some standard form of life insurance policy. The period within which conversion might occur was extended to 8 years in 1945.

The government's life insurance program has certain characteristics which point toward a substantial rise in future tax burdens in order to discharge the obligations incurred. These are:

1. A fixed group of policyholders, most of whom acquired policies in early mature life, a time when the premium rates would be favorable. Hence the annual premium income will be relatively small. For the calendar year 1944 the total premium receipts were \$51,488,000, and total income was \$128,268,000, while total disbursements for the same year on account of claims and other obligations were \$70,197,000.

2. A steady aging of this group, which will not be offset by a constant inflow of new, young policyholders as in the case of a private insurance company.

3. In consequence, a period will come in which the deaths among

this fixed, aging group will accelerate the drain upon reserve funds. These funds will necessarily prove inadequate because of the limited net annual inflow of premium receipts.

4. Therefore, large and increasing appropriations will be necessary to supplement the dwindling resources of the insurance program.

The administration of these various provisions for the care of the sick and disabled, and of their families, was distributed, during and immediately after the first World War, among several agencies. The Bureau of War Risk Insurance, the Federal Public Health Service, and later the Vocational and Industrial Rehabilitation Board shared in the task. In 1921 a Veterans' Bureau was created and placed in general charge of the problem of caring for the sick and disabled. This bureau did not, in its earlier years, fully and adequately meet its obligation, for the problem expanded rapidly in magnitude as the after-effects of the war strain and exposure began to appear. In 1930 an executive order consolidated the Veterans' Bureau, the Bureau of Pensions, and the National Home for Disabled Soldiers into an independent or non-departmental office known as The Veterans' Administration. This consolidation brought under one management the medical, hospital, and domiciliary services for all veterans, the administration of disability compensation and allowances for World War I veterans, the operation of the government life insurance business, the adjusted-service certificate or bonus administration, and various minor aspects of veteran care and compensation.

The war debt cost. The financing program used during the first World War led to what was then regarded as a tremendous expansion of the national debt. It was a war of incredible waste, the pattern for which had been established before this country was drawn into it. In all probability the resort to public credit could not have been altogether avoided, although it could have been held to a much smaller amount if simple and realistic methods of war taxation had been employed. The lavish tempo of war expenditure encouraged recklessness in financing, just as the war lust encouraged the wanton use of men and materials. In consequence, the federal debt rose from \$1,225 million on June 30, 1916, to \$25,482 million on June 30, 1919. The interest on this debt in 1920 was about \$360 million more than the entire cost of the federal government in 1915. The extent and severity of the economic and financial dislocation caused by the war are indicated by this growth in the public debt. Within three years the people had mortgaged their taxable capacity and their economic future by more than \$24 billion, not for the purpose of making productive investments which would correspondingly increase national income and well-being, but in order to engage in a destruction of wealth and man power thus far unparalleled in history.

During the 1920's a combination of fortunate circumstances permitted a reduction of the debt to \$16,185 million as of June 30, 1930. This

reduction lowered the interest cost for 1930 to \$658 million, or somewhat less than the entire cost of the federal government in 1910. At the time so great a redemption of national debt was regarded as a remarkable achievement, and so it was; but its fruits were of brief duration, for the ensuing decade witnessed a rise in the federal debt to approximately \$45 billion.

DEPRESSION AND RECOVERY EXPENDITURES, 1932-1939

It is not easy to present in brief compass a clear picture of the federal activities and expenditures during the difficult decade of the 1930's. The chief concern here is not with the voluminous detail of financial history, but with the broad issues of policy insofar as they were expressed in the amounts and the purposes of the expenditures. For that objective Table II is presented:

TABLE II
FEDERAL EXPENDITURES, GENERAL AND SPECIAL ACCOUNTS, 1932-1939 *
(MILLIONS OF DOLLARS)

<i>Agency or Purpose</i>	<i>1932</i>	<i>1934</i>	<i>1936</i>	<i>1938</i>	<i>1939</i>
I. General (including recovery and relief)					
A. Departmental	\$ 547.9	\$ 378.6	\$ 553.4	\$ 625.8	\$ 672.3
B. Agricultural programs	273.5	376.2	853.3	751.3	1,103.0
C. Federal loan agencies	500.0	207.3	55.7	24.9	18.3
D. Federal security agencies	31.2	358.4	596.2	717.6	758.3
E. Federal Works Agencies	295.0	349.5	1,564.6	1,772.0	2,734.6
F. Federal Emergency Relief Administration †	.....	1,512.5	496.3	4.6	1.9
G. Interest on the public debt	599.3	756.6	749.4	926.3	940.5
H. Veterans' Administration	784.8	506.9	577.9	582.0	557.1
I. Other	467.3	467.5	494.2	465.0	440.4
<i>Sub-total, general</i>	\$3,499.0	\$4,913.5	\$5,940.9	\$5,869.5	\$7,226.4
II. National defense	753.2	530.7	899.5	1,028.8	1,206.1
III. Transfers to trust accounts	221.1	71.1	1,814.2	219.7	182.2
IV. Revolving funds (net)	61.9	495.7	11.0	121.0	92.5
<i>Total, general and special (excluding debt retirement)</i>	\$4,535.2	\$6,011.0	\$8,665.7	\$7,241.8	\$8,707.1

* From *Annual Report of the Secretary of the Treasury*, 1941, Table 6, pp 454 ff Totals do not add because of rounding.

† Includes Civil Works Administration.

This table begins with the fiscal year 1932 for the reason that the expenditure records from that year onward have been classified uniformly. The distinction between general and all other expenditures is meaningless. It represents a phase of the struggle with terminology, in

the course of which several sets of terms were introduced and discarded, the purpose of the quest being to find expressions which would record the spending experiments without directing undue attention to their character.

Recovery and relief. The clue to the most significant changes that occurred in the character and the volume of the federal expenditures during the period covered by Table II is to be found in the parenthetical expression explanatory of the term *General*, i.e., "recovery and relief." It will be noted, by reference to the data given in Table I, that the annual totals of the so-called general expenditures exceeded the aggregate of all federal expenditures in any previous years except those embracing the first World War.

The words *recovery and relief* suggest very aptly the two paths that were being followed during this period. These paths were not necessarily parallel and their divergence, usually quite marked, explains in large measure the difficulty that was experienced in achieving satisfactory results under either heading.

The case for large public spending to bring about economic recovery after the depression was much weaker than the case for relief expenditures. There was distress which required alleviation, and there was good reason for government to take the lead in this relief, although there was never an unbreakable case for assumption of the entire burden of relief, as such, by the federal government. On the other hand, there was no great need of government intervention to stimulate economic recovery. What was principally required, in this respect, was evidence and assurance of a consistent and stable policy under which the necessary short- and long-range business planning could and would be undertaken.

Instead of such assurance, there was created an atmosphere of distrust, suspicion, and hostility toward private enterprise. Relief quickly ceased to be merely relief and broadened into a program of social reform, the scope and implications of which aroused grave concern for the future of private capitalism and individual enterprise. This concern was deepened by the virtual disappearance, for a time, of Congressional power and prerogative, with a corresponding enlargement of executive and administrative powers.

Under these conditions economic recovery was sluggish and fitful. The flood of federal spending produced an artificial prosperity by 1936 which promptly turned into a severe reaction in 1937-38 when the spending slackened. Instead of proving, as some assumed, that continued spending was essential to the maintenance of business activity, the whole experiment demonstrated that no vital and enduring forward movement can be achieved by such means.

Only a small part of the confused background of the federal expenditure program of the 1930's can be sketched here.

First, owing to deficiency of understanding and confusion of counsel, it was believed, particularly in the early part of this period, that lavish relief expenditures would create and sustain prosperity. This belief rested on the assumption that the reason for poor business was a lack of consumer purchasing power. Hence, it was argued that business revival could be generated by putting more purchasing power into the hands of consumers without regard to the character or value of any productive services which the recipients might have performed in exchange for this purchasing power. The common explanation of this policy was that it would "prime the business pump."

Second, the concept of a multiplier of the original expenditure was introduced to a dazed Congress and public. This concept means that when the government spends a dollar, the person receiving it will spend, on the average, a certain proportion of that dollar, and the next person will likewise spend a portion of his receipts, and so on indefinitely but in diminishing ratio. Thus, there would be an overall multiplication of the energy generated by the original expenditure. In one pamphlet widely circulated in the United States in 1933, the multiplier was estimated at 2 for England, and at more rather than less for this country.⁴ By the time the idea had been handed about enough to become thoroughly confused, a witness before the Ways and Means Committee could testify that he had heard, "on credible authority," that there could be put to work, directly and indirectly, a million men per billion dollars of expenditure, and that there would be created, from the expenditure of one billion dollars, a total increased purchasing power of from 8 or 10 to 15 billion dollars.⁵

Third, the problem of economic depression was interpreted by another group as one, primarily, of low prices rather than as one of deficient purchasing power. This group approached the matter by way of currency policy and it succeeded in bringing about gold nationalization, repudiation of the gold payment clause in public and private debt contracts, devaluation of the gold dollar, a wasteful and fruitless silver purchase program, and a threat of huge issues of Greenbacks. These changes and prospects had far greater adverse effect upon public confidence, especially with respect to long-range investments and business commitments, than any beneficial effect upon the level of prices. They went far toward destruction of the economic and psychological bases of sound recovery.

Finally, in all of the confusion of the period, the tactics of still another group were extremely significant, for its goal was the complete transformation of the American economic order into some form of state

⁴ J. M. Keynes, *The Means to Prosperity* (1933), Ch. 2.

⁵ *Hearings before the Committee on Ways and Means, House of Representatives, 73rd Congress, 1st Session, on H. R. 5664, pp. 75, 76.*

socialism. The methods used in furthering this objective ranged from personal attacks upon the integrity and capacity of businessmen to drastic increases in the rates of income and estate taxes with the avowed purpose of equalizing wealth and incomes.

The compact grouping of spending agencies and purposes in Table II conveys a false impression of simplicity. Actually, each category of agencies is as complicated as an anthill, and their operations would reveal as much futile scurrying about.

Under the new administration which took control in 1933, a mass of legislation was enacted to provide relief, promote recovery, and to correct various social and economic ills. An immense expansion of the civil organization at once followed and the resources of the alphabet were well-nigh exhausted in providing labels for these agencies within and without the regular departments. The separate corporation device, inaugurated during the first World War, was widely used. It is significant that the federal government patronized the liberal, charter-peddling states in organizing its corporations, although it was then engaged in an attack on the undesirable conditions which the loose requirements of these states had made possible in private corporation organization and management.

During the period covered by Table II the cardinal doctrine of fiscal policy was to spend and spend. Hence there was positive merit in the multiplication of agencies and in the expansion of personnel. Whether the work done was in any degree useful or economically justifiable was entirely minor, as it must necessarily be when spending, per se, is deemed to be a good thing.

It is both impossible and unnecessary to offer a full outline of the organization or the activities represented by any of the group headings in Table II. The following comments are intended to supply a bare minimum of description.⁶

Departmental expenditures. The departmental expenditures are those made by the civil departments, and the totals given here include also the judiciary, the legislative and executive branches. The figures for 1932 are relatively high because a large part of the relief then being undertaken by the federal government was handled by the regular departments rather than by special agencies.

Agricultural programs. The growth of expenditures under this heading is not so much an indication of an agricultural economic problem to be solved only by increasing the expenditures as it is a testimonial to the expanding political power of a so-called "farm bloc."

The two principal general purposes of the agricultural spending program have been (1) capital or credit aid, and (2) subsidies designed

⁶ For further, though still inadequate details, consult the *Annual Report of the Secretary of the Treasury*, 1941, pp. 454 ff.

to establish public regulation and control our agricultural production. The former purpose is the only one represented in the expenditures for 1932 and it was still relatively important in 1934. Thereafter, the various types of farm subsidy accounted for a large proportion of the total.

The technique of the subsidy policy has varied, yet the underlying objective has been that of increasing farm income by raising farm prices. The prices were advanced by the simple but effective device of curtailing production. Under the first Agricultural Adjustment Act the direct method of paying farmers not to produce was supplemented by wholesale, subsidized destruction of crops and young livestock. After the Supreme Court had ruled that farm operation was not interstate commerce,⁷ the same objective was achieved in a manner entirely satisfactory to the Court, by new legislation authorizing the establishment of quotas to be marketed, with appropriate—and adequate—penalties for sales in excess of the quota. To reconcile the discrepancy between higher farm prices to farmers and higher food costs to consumers, a system of food stamps was devised whereby the government subsidized the sale of various farm commodities and the outright donation of certain surplus products. Only those families on relief and those persons employed on WPA projects were eligible to obtain food stamps or donations of surplus commodities.

The agricultural program must be appraised as, on the whole, an unscientific approach to the problem, and as having been framed to serve political objectives. The unscientific character of the farm program is revealed by the following:

1. It compelled curtailment of production on good land as well as on sub-marginal land. Thus it deprived the owners of good land of an opportunity to remain economically and politically independent, and it deprived the consumers of an opportunity to buy the low-cost products from such land at a reasonable price.
2. It assumed that all farmers needed high prices in order to earn a fair return. The operators of good land could ordinarily do better with large volume and a lower price than they could with restricted volume and a higher price. Those on sub-marginal land could not do well even with the aid of a subsidy.
3. It assumed that there was enormous virtue in a grotesque idea called parity—first, parity of income, and second, parity of prices. Income parity is a statistical fraud, for there is no way of ascertaining with any accuracy either the farm or the non-farm incomes in the base period established, namely 1909-1914. Further, non-farm incomes cover such a wide range as to render any comparison of them with farm incomes futile as a guide to policy, even if the facts regarding these incomes were known. Price parity may be ascertainable, statistically, but it is likewise

⁷ *U. S. v. Butler*, 297 U. S. 1.

indefensible because the reference of any set of prices to those of some earlier period necessarily involves complete disregard of all of the technological and other changes which invalidate the comparison.

4. It has diverted attention from the fact that more and steadier industrial employment would have established a substantial market for agricultural products at prices which would have assured farmers a reasonable return without resort to subsidies.

5. It has ignored the effects of artificially maintained prices for export products upon the world market and upon the development of competing supplies for this market in other low-cost areas.

The essentially political character of the farm program is revealed by the following:

1. It is so devised that, in one way or another, some sort of payment will be made to virtually every farmer. This is indicated by the data in Table III.

TABLE III

ESTIMATED NUMBER OF PERSONS RECEIVING PAYMENTS IN 1942 UNDER AGRICULTURAL CONSERVATION PROGRAM AND PARITY PAYMENT PROGRAM, BY SIZE OF PAYMENTS *

<i>Size of Payment</i>	<i>Agricultural Conservation Program</i>	<i>Parity Payment Program</i>
\$ 0— \$ 20.00	1,815,133	557,518
20.01— 40.00	1,443,914	375,303
40.01— 60.00	806,089	248,279
60.01— 100.00	852,640	321,680
100.01— 150.00	444,043	238,636
150.01— 200.00	227,069	141,875
200.01— 300.00	148,080	138,047
300.01— 400.00	55,723	59,382
400.01— 500.00	25,639	26,462
500.01— 1,000.00	31,932	27,462
1,000.01— 2,000.00	7,937	4,429
2,000.01— 3,000.00	1,540	611
3,000.01— 4,000.00	545	206
4,000.01— 5,000.00	255	65
5,000.01— 10,000.00	306	38
Over \$10,000	...	17
<i>Totals</i>	5,860,845	2,140,011

* United States Department of Agriculture, Agricultural Adjustment Agency, Division of Special Programs, September, 1943.

The agricultural census of 1940 reported a total of 6,096,799 farms. In view of the changes wrought by the selective service and the war production program by 1942 in the occupational activities of farmers, it is likely that the number of payees receiving some amount of conservation payment corresponded fairly well with the total number of farms at that time. Parity payments are made to a smaller number since these payments

are paid only to the producers of certain crops. In both cases the high proportion of those who received small annual payments is striking. These amounts, even up to \$60.00, are too small to be of value, either as recompense for worthwhile conservation effort or as adjustment of differences in income toward some hypothetical parity.

2. It has given the federal administrative agencies an enormous power of regimentation, by means of which the theories of those in charge of policy can be carried out without any need of proving their wisdom or advantage.

The most amazing fact about the agricultural program is the ease with which the farmers were deprived of their freedom of choice. In European countries the socialist movement has always met its stiffest resistance from the agrarian interests, and it had generally been assumed that such would be the case here. Yet the softening up of the agrarian group in this country was surprisingly easy, because it was accomplished by a device that lay outside the orthodox Marxian technique. This device is the subsidy, financed by deficits and productive of a continuous inflation that converts the struggle for parity into a process of rainbow-chasing.

Federal loan agencies. The federal loan agencies began with the Reconstruction Finance Corporation, created in 1932. Its capital of \$500,000,000 was the only expenditure of this character in that year. By 1934 the Home Owners' Loan Corporation and the Federal Savings and Loan Corporation had appeared. The Federal Housing Administration and the Disaster Loan Corporation were later additions to the group of lending agencies. The expenditures shown in Table II under this heading refer only to disbursements from the Treasury by way of advances to these corporations in purchase of capital stocks or notes. The operations of the several corporations, financed by sale of their own obligations, have aggregated billions of dollars which do not appear in the accounts of the federal government.

Federal security agencies. The expenditures under the heading of security agencies are those for the Civilian Conservation Corps, the National Youth Administration, and the Social Security Board. Among these the CCC absorbed the greater part through the year 1935 although the total spent by this agency declined after 1936. This decline was partially offset by a rise in the expenditures of the National Youth Administration. The administrative expenses of this organization are classified with the Works Projects Administration in the Treasury's revised exhibits.

Social Security Board expenditures included in Table II include administrative expenses, the grants to the states for public assistance purposes and certain other unclassified amounts. The expenditures for old age benefits and unemployment compensation are handled as payments from trust accounts and are not included in Table II.

Federal works agencies. The expenditures grouped under this heading include those for public buildings and public roads, and also those by the several agencies that were set up for the purpose of pump-priming and relief. The Federal Emergency Relief Administration belongs here in part, also, since a portion of its activity concerned public works of a sort.

The collapse of the initial large public works program, authorized by the National Industrial Recovery Act of 1933, led to the hastily improvised Civil Works Administration, for the purpose of giving relief through employment on "made work" that required no elaborate planning. This agency spent \$805,122,000 in the fiscal year 1934. In the next year emergency relief came to the fore, and the FERA spent \$1,821,000,000. Thereafter the ball was carried by PWA and WPA. After authorizing appropriations of \$3,300,000,000 in 1933 and \$4,800,000,000 in 1935 for the general purposes of relief through public works and in other ways, Congress balked at a third request of similar character, known as the "lend-spend" bill, in 1939. This did not prevent the spending, in that year, of the largest total yet achieved by the public works agencies. Defeat of the "lend-spend" proposal was the result of party discord produced by the Supreme Court packing proposal and the administrative reorganization bill, and of spurious claims made that the projects to be financed would be self-liquidating. No such claims had been made, or could legitimately have been made, with respect to the great bulk of the expenditures made under the appropriations for public works and relief.

Interest on the public debt. This item requires no explanation. Reference to Table I shows that the peak load of interest payments following the first World War came in 1920. Although the debt began to rise after 1930, the low point in interest payments was established in 1932. Since that time, the annual interest cost has risen relatively less rapidly than the debt principal, because the new borrowing and the refunding of outstanding debt were done in a low-cost market. The stream of private securities declined to a mere trickle, and various aspects of the government's monetary and fiscal policy combined to create large excess bank reserves. This condition was maintained by continuous manipulation, and it increased the deceptive attractiveness of deficit financing by permitting a demonstration to be made of the extremely moderate cost of adding to the public debt.

Veterans' Administration. The experiences of earlier post-war generations with increasing demands for pensions and similar awards have been repeated since the first World War. Pressure continually develops for additional compensation, and there is as yet no end in sight to these demands. Various states provided compensation for their own citizens, and some granted special tax exemptions. Action on compensation legislation by Congress was deferred by the depression of 1920, which tempo-

rarily turned the attention of the country toward economy. An adjusted compensation law was finally enacted in 1924, over the presidential veto. It provided for two forms of compensation—a cash payment to all whose period of service was such as to entitle them, under the schedule as finally established, to sums under fifty dollars. For all others, the adjusted compensation was issued, in certificate form, for an amount equal to the amount in dollars of twenty-year endowment insurance that the adjusted service credit, increased by 25 per cent, would purchase at the applicant's age, if applied as a single premium, calculated on the American Experience Table of Mortality and at 4 per cent interest compounded annually. Banks in the federal reserve system were authorized, after two years, to accept these certificates as collateral security for loans to a maximum of 90 per cent of their surrender value, and the paper thus secured was made eligible for rediscount by the federal reserve banks. From September, 1924, to June 30, 1935, certificates were awarded to 3,732,485 applicants, for a total of \$3,680,943,000. In the same period lump sum cash payments totaling \$51,295,000 were made to 293,617 applicants.

The present loan value of the certificates outstanding on June 30, 1935 was approximately \$1,750,000,000. On that date 2,904,525 certificates had been pledged with the Veterans' Administration for loans and interest thereon amounting to \$1,679,670,000. The certificate holders had evidently been inclined to absorb the available loan value as it accumulated.

From the Treasury point of view, the merit of this method was that it deferred final settlement of the bill for 20 years. In theory, that period could be used to accumulate a reserve fund for redemption, and a policy of "investing" certain sums annually in adjusted service certificates was begun. Actually, such a reserve, like all other reserves established by government, is illusory.⁸

From the viewpoint of the beneficiaries, the adjusted service certificate presented the drawback that it provided them with no money to spend at once. Like insurance, there would be no cash available until the maturity of the certificates, and the veterans took the eminently practical position that cash in hand was vastly preferable to cash 20 years later. The extent to which they continued to absorb the loan value of the certificates is eloquent on this point.

The slow accretion of loan value proved irksome, and after 1924 there was persistent agitation for advance redemption of the certificates at their maturity value. During the depression years the pressure to this end was fortified by the plausible argument that any device for payment, even the printing of paper money for this purpose, would add to total purchasing power and thus give further upward impetus to prices at a time when the government was making efforts in this direction along a wide front.

⁸ Cf. *infra*, pp. 53-55.

As of June 30, 1935, the so-called balance in the adjusted certificate fund was \$1,205,272,000, or only about one-third of the amount that would have been required to redeem all certificates at face value. In 1935 a bill to redeem all certificates immediately at full value by the issue of non-interest-bearing United States notes in the amount required above the Treasury balance was vetoed, and the House passed it again. The President's veto was sustained in the Senate by a margin of two votes.

The organized demand was too strong to be resisted in 1936, a general election year, and a presidential veto of a similar bill was overridden. The act, written by leaders of three veterans' organizations, provided for immediate payment of the full maturity value of the certificates, in bonds of the denomination of \$50, registered in the name of the veteran. Any balance above the highest multiple of \$50 was to be paid in cash. The bonds were to be dated June 15, 1936, and to mature on June 15, 1945; but they were redeemable at the option of the veteran or his estate at any time, at such places, including post offices, as the Secretary of the Treasury might designate. Interest was to accrue on them at 3 per cent, and was to be paid, together with the principal, at maturity, or at redemption. No interest was to be paid on any bond redeemed before June 15, 1937.

Any loans and unpaid interest accrued prior to October 1, 1931, were to be deducted from the face value of the certificate, and the balance, if any was to be paid to the holder. All unpaid interest on certificate loans that had accrued since September 30, 1931, was to be paid for the borrower by the government without being charged against the maturity value. In other words, those who had borrowed after that date but had paid no interest were to have their interest obligation cancelled.

Certificates held by the government life insurance fund as security for loans should be redeemed by the Secretary of the Treasury, by issuing and delivering to the fund bonds of the United States in the amount of the liens, together with interest due or accrued. These bonds were not to mature for at least ten years, but were to be redeemed in such amounts and at such times as might be necessary to provide funds for meeting the current liabilities of the fund. Presumably the unpaid interest since September 30, 1931 was to be cancelled for the certificate holder, as was the case with other loans.

Comment on this treasury raid would be superfluous in view of the President's message vetoing the somewhat similar bill in 1935. A large proportion of the bonds issued was promptly presented for redemption. Naturally, they could be redeemed only by selling general treasury obligations in the market to an amount sufficient for the purpose. Expenditure of the funds so obtained does not appear in Table II, since it was handled as an operation involving trust funds. The aggregate transactions in the adjusted certificate fund for the years 1936 and 1937 were

\$3,511,000,000, and the total charged as expenditures from trust funds for the same purpose in these years was \$2,462,000,000. The balance evidently represented a redemption of the certificates which had been slowly accumulated in the adjusted compensation fund since 1924.

National defense. In Table II the expenditures for all branches of national defense are combined. In view of what was destined to happen to the peace of the world in 1939, the most surprising thing about the expenditures for national defense is their relatively small proportion of the total. This is emphasized by the following comparison:

TABLE IV
RATIO OF EXPENDITURES FOR NATIONAL DEFENSE TO TOTAL ORDINARY EXPENDITURES
EXCLUSIVE OF DEBT RETIREMENT *

<i>Fiscal Year</i>	<i>Ratio</i>	<i>Fiscal Year</i>	<i>Ratio</i>
1923	19.0	1933	15.7
1924	19.8	1934	8.3
1925	19.7	1935	9.0
1926	19.3	1936	9.9
1927	21.4	1937	11.2
1928	21.8	1938	14.1
1929	21.0	1939	13.7

* Compiled from data in the *Annual Reports of the Secretary of the Treasury*. National defense expenditures do not include expenditures made under the jurisdiction of the War Department for rivers and harbors, and the Panama Canal. Debt retirement is excluded in the first period since there was none in the second period.

The proportion of total expenditures devoted to national defense during the first period shown in Table IV was double that of the second period (the average for 1923-1929 was 20.3 per cent, and for 1933-1939 it was 10.2 per cent). Yet during the 1920's, there was no sign of war and there was some indication that the restriction of armament agreed upon at the Washington Conference of 1922 would prevent war. Coupled with this limitation was the Nine-Power Treaty and other arrangements designed to assure peace.

In contrast, the period since 1933 was one which was marked by denouncement of international agreements, by an obvious growth of armament in many nations, and by a rising tide of aggressive acts obviously aimed at conquest. Despite these indications, and despite plain statements of intention by the leaders of some countries, those in charge of policy in the United States reduced by one-half the proportion of total expenditures that was devoted to defense by comparison with the proportion spent for this purpose during a period when no one could foresee another world conflict.

Table II provides an explanation. It indicates that the primary objective of policy during the 1930's was social reform. To this objective, both economic recovery and national security were really secondary.

The political advantages of "boondoggling" expenditure were so decisive as to obscure the fact that neither economic, nor social, nor national security is to be achieved by such means. In one of the most critical decades of the nation's history, the formulation of public policy fell into the hands of the social workers, and the social work viewpoint was naturally and necessarily not adjusted to the range of vision required to perceive the dangers of inadequate defense in a world that was openly preparing for war.

A rebuttal to the ratios shown in Table IV might be that various other agencies were engaged in promoting the national defense, although their expenditures of this character are not credited to this category. Hence, it might be alleged that the true proportion of defense to total expenditures during the 1930's was higher than is indicated in Table IV. In a vague way, any public expenditure can be rationalized as one to promote national defense. No acceptable criterion is available for judging the merits of various activities from the standpoint of their contribution to defense. When the campaign developed to secure reductions in non-defense federal spending, in 1941, the WPA projects were quite generally given a defense label, although no change was made in the specifications of these projects.

Transfers to trust accounts. The annual reports of the Treasury contain the following standard definition of a trust account:⁹

Trust account receipts represent moneys received by the Government for the benefit of individuals or classes of individuals and are used for purposes specified in the trust. Moneys held in trust, being payable to or for the use of beneficiaries only, are not available for general expenditures of the Government.

The amounts shown in Table II as transfers to trust accounts are the sums which were taken out of the overall receipts and put aside as funds in trust. Illustrations are the adjusted certificate fund, the government employees' retirement fund, and the railroad retirement account. The abnormal amount shown for the year 1936 includes that part of the adjusted compensation or veterans' bonus bonds which was redeemed in this fiscal year. The amounts appropriated for old age benefits are now transferred to a trust account.

The definition quoted above, and the whole concept of a government trust account, are none too realistic, however correct they may be as matters of accounting. Thus, the definition refers to "moneys held in trust." To the ordinary person this suggests a cash balance, or at any rate some kind of asset capable of ready conversion into cash. While it is true that there are certain cash balances actually in hand for the various trust accounts, the following matters are also true:

⁹ Cf. *Annual Report of the Secretary of the Treasury*, 1941, p. 407.

1. The Treasury no longer publishes the amounts of these balances. Since July 1, 1938, they have been included with the general fund, with no indication of the segregation, as shown by the accounts, between general fund cash and trust fund cash.¹⁰

2. The total amount shown in a trust fund account is merely a book-keeping method of registering an obligation of the government with respect to the beneficiaries of that fund. For example, the payroll taxes collected for old age benefits are appropriated to a trust fund, but they do not and cannot accumulate as a cash balance of that fund. They are automatically invested in special securities issued by the Treasury for the purpose, and this investment transfers the amount appropriated back to the general fund. In short, the government borrows from the social security fund instead of from the market. The special securities are not negotiable. When it becomes necessary to make payments to beneficiaries by withdrawal from the trust account, the Treasury sells notes or bonds and uses the cash to redeem the special obligations held by the social security fund; thereby making available in the trust account the funds required for disbursements according to the purposes of the trust. A similar procedure is required in the case of all other trust funds, although in some instances there may be authorization to invest them in securities other than those issued by the government.

The impossibility of accumulating huge public trust funds in any other form than as a government debt raises the question of the propriety of so-called trust or reserve funds for such purposes as service retirement or old age pensions. If the government is operating on a deficit basis, the annual transfers to the fund become a means of financing the deficit without resort to the market. If the budget is in balance, the funds would be available for debt retirement.

And if there be no public debt, it will be necessary to create one, to the extent of the accumulation. In short, the process of accumulating reserves inevitably means that the current collections from beneficiaries and others will be currently spent and that the government will be in debt to the fund. It is equally inevitable that final performance of the obligation to the beneficiaries of a trust reserve will not be possible without borrowing cash with which to redeem the special debt certificates held as assets in this reserve. That is, the debt must eventually be transferred from the fund to the public.

¹⁰ Cf. *Annual Report of the Secretary of the Treasury*, 1938, p. 17, for an account of this change. D. T. Selko in his *Federal Financial System*, p. 338, says the General Fund "is not really a general fund in the accounting sense, because money credited to the General Fund is not restricted to general government purposes, but is available as well for meeting special and trust fund obligations. To be precise, the so-called General Fund should be referred to simply as Treasury cash." But the failure to show trust fund balances separately raises the question of the possibility of using these trust funds, temporarily at least, to meet general fund obligations.

The advantages of this kind of financial management are illusory. It is a bookkeeping device and its sole practical advantage is in the record of contributions and obligations which is established. But this record can be set up without the misleading hocus-pocus of a reserve that consists of nothing more than the government's promises to pay. The beneficiaries, such as civil servants or private workers, are led to believe that what they contribute toward a retirement pension is put aside somewhere for them. This is not true, nor is it true that a trust fund which shows a balance of a million or a billion dollars is a better guarantee that those entitled to retirement allowances or other benefit payments will get them than if the necessary sums were currently budgeted, collected, and paid out as individuals become entitled to receive them. The moral risk of a change of policy is not lessened by the creation of government debt to be held as a reserve.

Furthermore, it does not follow that a large trust fund consisting of government IOU's can make the load easier to carry, except as it means that a part of the load is to be financed eventually by indefinite debt expansion. In the long run it would be better policy to eliminate, or at any rate to minimize the emphasis upon trust funds, especially for such huge undertakings as pensions and benefits, and to establish these commitments on a current, cash basis. Each year there should be collected from prospective beneficiaries the amounts required to cover the current obligations with respect to present beneficiaries. The government employees, and those in private employment entitled to receive an old age pension, would thereby earn their own respective retirement pay by contributing, during active life, to the support of those who had preceded them into retirement.

Huge trust fund operations may provide both an incentive and an opportunity for liberal, not to say unwise spending. The amounts collected currently under the social security legislation, for example, greatly exceed the current obligations. It is easy to regard these surplus receipts as an extra rather than as an offset to other exactions which, under prudent budgetary management, might be reduced correspondingly. The day of reckoning is still far off; the people believe that their security payments are being accumulated in some mysterious way and place for their benefit; and a large deficit can be financed, temporarily, without exposing the fiscal policy so completely to the critical scrutiny of the general market. The government's debt to its trust funds becomes a kind of secret debt, in the sense that the public generally is not aware of the details or the significance of this policy.

Revolving funds. As the term implies, a revolving fund is one which is supposed to return via repayment to the issuing agency and is then to be put out again. Expenditures of this character shown in Table II are the initial advances for various purposes, together with the balances of

TABLE V
SUMMARY OF FEDERAL FINANCES, FISCAL YEARS 1940 THROUGH 1947 *
(BILLIONS OF DOLLARS)

	1940	1941	1942	1943	1944	1945	1946	1947
A. Expenditures:								
1. War:								
a. Budgetary	1.7	6.3	26.0	72.1	87.0	90.0	—	—
b. Government corporations † .....	...	.4	2.3	3.2	2.7	.5	—	—
c. Total	1.7	6.7	28.3	75.3	89.7	90.5	48.5	19.0
2. Other:								
a. Interest on public debt	1.0	1.1	1.3	1.8	2.6	3.6	4.7	5.0
b. Refunds of taxes and customs, including excess profits tax refund bonds .....	.1	.1	.1	.1	.3	1.7	3.0	1.8
c. Veterans' pensions and benefits .....	.6	.6	.6	.6	.7	2.0	4.2	6.2
d. Other budgetary expenditures	5.7	4.6	4.5	3.6	3.1	3.0	4.5	9.0
e. Government corporations † .....	.3	.7	—4	—1.7	—1.2	—8	1.3	.5
f. Total	7.6	7.1	5.9	4.4	5.6	9.5	15.1	17.6
3. Total expenditures	9.3	13.8	34.2	79.7	95.3	100.0	63.6	41.5
B. Receipts §	5.4	7.6	12.8	22.3	44.1	46.5	43.0	39.6
C. Excess of expenditures	3.9	6.2	21.4	57.4	51.1	53.5	20.6	1.9

* Figures are on the basis of a classification appearing in the 1946 Budget Message. Data for 1946 and 1947 are from the August, 1946 budget statement. They include net expenditures of government corporations and the totals are not, therefore, the same as the figures in certain other tables in this report. They exclude statutory debt retirements and trust funds. Note that figures are rounded and will not necessarily add to totals.

† Includes only Treasury outlays for the war activities of the Reconstruction Finance Corporation and its affiliates. Figures are excess of expenditures over receipts.

‡ Comprise principally Treasury outlays for Commodity Credit Corporation, Home Owners' Loan Corporation, and non-war activities of Reconstruction Finance Corporation and its affiliates. Figures are excess of expenditures over receipts. Negative figures indicate excess of receipts.

§ Net budgetary receipts, i.e., total receipts less net appropriation to federal old age and survivors' insurance trust fund.

reissues over repayments. Advances greatly exceeded repayments in the early years of the period covered. In later years, the amounts put out by the Farm Credit Administration were less than the repayments of earlier advances. This was true also of the Federal Farm Mortgage Corporation. PWA loans and grants to railroads have likewise been repaid almost *in toto*, but the loans and grants of this agency to states and municipalities have shown no excess of repayments from the beginning.

DEFENSE AND WAR EXPENDITURES, 1940-1945

Many details of the expenditures for defense and war from 1940 to the end of the second World War in 1945 are still held in secrecy. The successive budgets of this period requested huge blanket sums or indicated that such amounts as were found to be necessary would be requested of the Congress from time to time. Only the barest general summary figures have been issued. Table V presents such a summary, which will serve to indicate the overall course of the war expenditures.

The difficulty of expanding the fiscal operations by about tenfold from 1940 to 1945 will be paralleled by that involved in post-war contraction. Already the first steps toward reduction have been taken, and the budget estimate for the fiscal year 1947, with its total of \$41.5 billion, reveals the progress made in the first full fiscal year of peace. But this was the easy part of the road. Heroic resistance to spending pressures will be required to achieve a sufficient further compression to bring the budget into balance at a level that will assure substantial relief for the taxpayers.

Even so, the lowest feasible level of the post-war federal expenditures will be far above the pre-war standard. Again it will be demonstrated that war always leaves, as a permanent heritage, a new high level of government costs, though not necessarily a new high level of prosperity and well-being.

CHAPTER V

State and Local Expenditures

PRIOR TO THE first World War, the activities of state and local government constituted the major element of governmental services, as reflected by relative expenditures. Thus, in 1913, the total payments of state and local units for ordinary operations were about \$1,860,000,000, while in that year the federal expenditures for similar purposes were only about \$700,000,000. In addition, the payments for interest on debt by the states and their subdivisions were some \$164,000,000, as against approximately \$23,000,000 for this purpose by the federal government.

This relationship was reversed by World War I and by the changed economic and political philosophy which emerged after that conflict. Although the movement toward a stronger national government has become a veritable tidal wave in recent years, the states still retain their place and their operations are far from unimportant. This chapter presents, in summary form, such data as are available relative to state and local functions and expenditures.

STATE EXPENDITURES

Comparative data relative to state expenditures are available only since 1902. A summary of the record from 1902 to 1944, at approximately decennial intervals, is presented in Table VI.¹

The figures in Table VI present the general trend and sweep of state expenditures over a period of about four decades. The relative increases during this time have been stupendous. The total payments for operation and maintenance have risen eightfold from 1902 to 1944. Interest payments showed an even greater relative increase to 1932, but the reduction of state debts, particularly during the war years which brought phenomenal revenues into the state treasuries, has made possible a gratifying decline in this charge.

The various cross-sections of state governmental activity, shown at ten-year intervals, reveal the changes that have occurred in the relative

¹ The figures for 1902 and 1913 are from the special reports of the Census Bureau on *Wealth, Debt and Taxation*; those for 1923, 1932 and 1942 are from the same bureau's publication, *Financial Statistics of States*.

TABLE VI

TOTAL AND PER CAPITA EXPENDITURES OF THE STATES FOR CERTAIN YEARS *
(TOTALS IN MILLIONS OF DOLLARS, PER CAPITAS IN DOLLARS AND CENTS)

Class of Expenditure	Years							
	1902		1913		1923		1932	
	Total	Per Capita	Total	Per Capita	Total	Per Capita	Total	Per Capita
I. Operation and maintenance								
General government	25.9	0.32	40.5	0.42	77.8	0.71	123.3	0.99
Protection of life and property	6.8	0.08	24.9	0.26	52.8	0.49	86.9	0.70
Development and conservation of natural resources	3.2	0.04	†	†	46.2	0.43	73.0	0.59
Health and sanitation	5.3	0.07	6.4	0.07	22.4	0.20	37.3	0.30
Charities, hospitals, and corrections	52.5	0.65	87.3	0.90	172.2	1.57	274.9	2.20
Highways	4.7	0.06	13.6	0.14	108.7	0.99	235.7	1.89
Education	16.0	0.20	51.3	0.53	126.5	1.15	201.0	1.61
Recreation	1.6	0.02	2.0	0.04	2.6	0.02	8.1	0.06
Miscellaneous	9.5	0.12	3.8	0.04	63.2	0.58	57.1	0.46
Total operation and maintenance	125.6	1.35	220.9	2.52	672.7	6.14	1,097.2	8.80
II. Interest	9.6	0.12	14.2	0.15	50.4	0.46	112.3	0.90
III. Outlays	2.1	0.03	48.4	0.53	351.6	3.20	885.8	7.12
Total operation, interest, and outlays	137.3	1.70	292.4	3.20	1,074.8	9.80	2,095.3	16.82
							2,521.7	18.27

* Comparative data for state expenditures are available only since 1902.

† Not available

emphasis upon service responsibilities at the state level. In 1902 state participation in the cost of highways, protection, health and sanitation, and recreation was slight. The expenditure for development and conservation of natural resources was very largely limited to agriculture. The one conspicuous state service at this time is that represented by the expenditures for charities, hospitals, and corrections. Aside from the overhead costs of general government, education was in second place, though far behind the welfare service in the matter of cost. As the twentieth century opened, the nation stood at the threshold of the great changes that were to come. The picture of state activities provided by the summary of expenditures in 1902 is the product of the gradual developments of the nineteenth century, with its emphasis upon the care of those social groups which presented peculiar problems of support or discipline, and upon education. The centralizing tendencies that were in evidence during the later years of the last century were then operative chiefly in these fields. Higher education was regarded as a state function, insofar as it was to be supported by the public. Among the social problem groups, persons under sentence and the insane were the first to be provided for on a large scale in state institutions.

The capital outlays during the opening years of the present century were also extremely modest. Buildings and other equipment for state universities and other state institutions then corresponded, in style, facilities, and cost, with the moderate standards of the time.

The old shell of moderation in state spending was first broken during the decade in which occurred the first World War. The experience of the states paralleled that of the federal government in moving up into a new high plateau of spending. The federal costs had been greatly inflated by the war spending but the states had no material direct participation in those costs. Yet their own spending increased in response to all of the inflationary forces of the war period.

The most noteworthy expansion during the years between the end of the first World War and the climax of the great depression in 1932 occurred in the capital outlays. This was the period in which the highway system was transformed from dirt and gravel to hard-surfaced roads. In consequence, the payments for interest and capital outlays in 1932 were almost equal to the total cost of operation and maintenance. The capital expenditures were materially reduced after 1940, as the prior claims of the war effort restricted the availability of labor and materials for all non-military construction and production. Because of these restrictions, substantial increases in the expenditures for new capital construction are likely to occur in the post-war years.

State welfare expenditures. The phenomenal rise of the welfare expenditures from 1932 to 1944 is both impressive and alarming. The subject is one which it is difficult to discuss in a wholly objective manner,

since the line between sympathetic warmth and prudent fiscal considerations is not easily observed. The level to which the welfare expenditures has risen, and more significant still, the sharp upward trend which has appeared in recent years and which has scarcely been affected by the war prosperity, compel thoughtful attention to the problem.

Great impetus to welfare spending was given by the entrance of the federal government into this field in the early 1930's. The depression which began in 1929 was accompanied by extensive unemployment which proved singularly unresponsive to all of the fiscal and other devices that were supposed to restore prosperity. Consequently, the relief load provided opportunity for the introduction of spending policies and techniques which have sustained the total outgo for welfare, notwithstanding the decline in the case load, that is, the number of persons or families receiving assistance.

Three stages may be distinguished in the development of welfare spending since 1930. The first includes the years 1930 and 1931, and is marked by reliance upon local governments to handle the relief aspects of the welfare problem. Their share of the total was 84.9 per cent, excluding such small amounts as the federal government may have put in during that time. The second stage embraces the years 1932-1935. This period was marked by federal expenditures which greatly exceeded the total spent by state and local governments combined. For the four years, total federal expenditure on relief and assistance, aside from WPA, was \$2,311.7 million. The total state expenditure was \$634.4 million, and the total local expenditure was \$1,025.7 million, in the same time.²

A third stage began in 1936 with the social security legislation. The Social Security Act established a double-barreled system of security provisions. One is known as Old Age and Survivors' Insurance, consisting of old age benefits to persons who have made contributions and also to the survivors—widows and dependent parents or children—of such persons. The other is a program of joint federal and state support of certain groups of needy persons—the aged, dependent children, and the blind. These persons may or may not be eligible for insurance benefits. If, after receiving such benefits, they are able to make a case for further aid on the basis of need, they would likewise become eligible for assistance grants under the appropriate category.

Different bases of payment are established for the two systems. The old age and survivors' benefits are related to the duration of employment and the wages earned in a covered industry, although they are not strictly proportional to these factors. On the other hand, the basis of eligibility for aid under the federal-state assistance program is need. The foundation element of the latter program is the monthly amount which the federal

² Cf. *Social Security, Its Present and Future Fiscal Aspects*, The Tax Foundation, New York, 1944, p. 44.

government will pay under the rule that the federal payment shall equal half of the total grant. In consequence, the amount received as an assistance grant may exceed that to which an aged person or his dependents would be entitled under the OASI³ formula. In January, 1945, for example, the average monthly payment to a retired male worker was \$24.00, while the average old age assistance grant was \$28.52.

There still remains a substantial group of persons who are more or less regularly in need of assistance, but who are not included, for one reason or another, in either of the programs established by the social security law. This is the field of general relief. Although the federal government had spent heavily for general relief purposes through 1935, it promptly withdrew from this field after the enactment of the social security legislation. The general relief task was thereafter left to the states and their local subdivisions, principally the cities. Ordinarily the cost is shared in some proportion between state and local funds.

With respect to the jointly supported assistance program, the procedure has been for the federal government to reimburse a state for half of the amount spent, up to the maximum monthly grants specified by the federal law, and for a certain part of the administrative costs. The states may assume the entire cost of their share, or apportion it between state and local treasuries in any manner preferred. A state is free to set a standard of payment below the federal maximum, in which case it would be reimbursed for half of the actual expenditure. Or a state may set standards of assistance for any of the special groups at levels above the maximum amount for which it would be reimbursed. Thus, the rule has been that a state would be reimbursed for half of an old age assistance grant up to \$40.00 per person per month. If a state were to pay \$30.00 a month, it would receive \$15.00 from the federal government; but if it were to allow \$60.00, it would receive only \$20.00 as reimbursement.

In 1946 new maximum levels for federal participation were introduced for each of the three categories of public assistance, that is, the aged, dependent children, and the blind. Instead of federal reimbursement of one-half of any grant up to the maximum, there is now a larger federal share of a certain proportion of the total. In the case of old age assistance, for example, the new maximum is \$45 per month. The federal share is to be two-thirds of the first \$15 of the grant, and one-half of any amount above \$15, but not over \$45. Thus, a state which paid an old age grant of \$45 would have received \$22.50 from the federal government under the former rule, but in future it will receive \$25. If a state should pay a grant of \$60, it would still receive only \$25 as federal reimbursement. The same principle is applied in reimbursing for grants made to dependent children and the blind, although different maximum levels are applied in these cases.

³ This abbreviation is commonly used for Old Age and Survivors' Insurance.

The relation of federal contributions to total payments for assistance to the three classes of recipients included in the joint program since 1936 is shown in Table VII.

TABLE VII
PERCENTAGE OF FEDERAL CONTRIBUTIONS TO TOTAL PAYMENTS FOR ASSISTANCE TO SPECIFIED CLASSES OF RECIPIENTS, 1936-1944 *

Calendar Year	Percentage of Federal Contribution to Total Assistance Cost		
	Old Age Assistance	Aid to Dependent Children	Aid to the Blind
1936	42.8	12.9	21.5
1937	48.5	24.4	30.8
1938	47.9	26.1	25.1
1939	48.0	25.5	25.9
1940	49.8	39.2	28.8
1941	49.8	39.5	29.3
1942	49.2	40.8	31.6
1943	48.4	39.0	33.3
1944	47.5	37.3	37.3

* Compiled from *Social Security Yearbooks*, issued by The Social Security Board, Washington; and *Issues in Social Security*, a report to the Ways and Means Committee, 1946

The federal grants in support of old age assistance have been well up to the halfway mark, which indicates that the states have not done much by way of making payments in excess of the amounts established as the basis of federal participation. With respect to the other two categories, the fact that the federal share is substantially less than half of the total expenditure suggests that the states have been making grants well above the levels at which the federal government reimburses for half of the cost.

The point of particular significance in the present connection is the extent to which the assistance program is likely to be developed in such manner as to involve the states in a burden, in the determination of which they may have little or no voice. The discussion is therefore limited to those aspects of the relief and assistance problem in which federal grants are involved. There is no need to consider the payments under OASI, although the question of their adequacy may be indirectly involved in the event that substantial numbers of such beneficiaries are obliged to apply for and are able to qualify for supplemental assistance on a need basis. In this case the states would be required to share in the cost of taking care of a group of persons for whose old age or dependency provision had presumably been made through contributions by these persons and their employers. The federal government has made no direct payments for general relief for a decade, except as cases formerly dealt with through such relief may have been transferred to one of the special

categories. Consequently the states will have complete control over this aspect of public assistance unless some one of the legislative proposals that have been advanced were to be enacted, whereby the entire assistance program would be consolidated with a view to extending federal participation and domination, or the federal government would participate in general assistance as a "fourth category," so to speak.

Federal domination of state policy in the area of the specially designated categories of persons to receive assistance extends, as yet, mainly to the rules and requirements laid down. The federal grants are conditioned upon acceptance and compliance with the following general provisions:

1. Statewide operation
2. Financial participation by the state
3. Administration or supervision by a single state agency
4. Fair hearing for applicants denied assistance
5. Proper and efficient administrative methods, including a merit system
6. Reports as required by the Social Security Board
7. Consideration of other income and resources of applicants
8. Safeguarding the confidential nature of records

The Social Security Board shall approve any state plan which fulfils the above conditions, but it may still reject the plan unless it also provides for certain other matters. These are that no age requirement in excess of 65 years may be set, that certain specified rules of residence shall be observed, and that no citizen may be excluded by any sort of citizenship requirement.

These provisions may seem harmless enough, and they are likely to be defended as a proper insistence upon uniform standards of operation. Moreover, it is true that no state is obliged to accept the federal aid. A few states have not accepted the federal programs for dependent children and the blind. But the point is that whatever conditions are made must be accepted if federal funds are to be received. Once this degree of control has been accepted, the grant system itself becomes a means of exerting pressure, to which the resistance is lessened by the naïve belief that the only burdensome part of the expenditure is that which the state itself makes.

The growth of total expenditures for the several categories of assistance and the variations in average monthly case load are shown for the period 1936 to 1945 in Table VIII:

These data indicate a steady rise of cost regardless of the changes in average case load. The total expenditure for dependent children declined after 1942 with a drop in the case load, but even here the higher basis of payment may be seen by comparing the years 1938 and 1945. With virtually identical case loads, the cost in 1945 was more than 50 per cent above the cost in 1938.

TABLE VIII

TOTAL EXPENDITURES AND AVERAGE MONTHLY CASE LOADS UNDER TITLES I, IV AND X
OF THE SOCIAL SECURITY ACT *

Calendar Year	Old Age Assistance		Aid to Dependent Children		Aid to the Blind	
	Amount (Millions)	Average monthly case load	Amount (Millions)	Average monthly case load	Amount (Millions)	Average monthly case load
1936	\$155.2	737.0	\$ 49.7	147.0	\$12.8	42.8
1937	310.4	1,369.2	70.5	194.2	16.2	50.7
1938	392.4	1,691.9	97.4	258.8	19.0	62.4
1939	430.5	1,851.8	114.9	305.4	20.8	68.3
1940	475.0	1,982.8	133.2	347.2	21.8	71.5
1941	541.5	2,163.3	153.2	386.6	22.9	74.5
1942	595.9	2,242.7	158.5	386.2	24.7	78.7
1943	651.9	2,170.7	140.8	303.3	25.1	77.1
1944	693.2	2,090.8	135.5	259.0	25.1	72.9
1945	726.4	2,044.1	149.7	258.9	26.6	70.7

* Compiled from *The Social Security Bulletin*, issued by The Social Security Board

The two reasons that naturally come to mind in explanation of the rising cost trend shown in the above table are, first, economic pressure expressed as the advancing cost of living, and second, political pressure.

It is probably reasonably correct that the political pressure is rooted in the economic circumstances of a segment of the population. In some respects the federal government is more responsive than the state and local governments to the demands made. Since it is most unlikely that a federal agency can be a better judge of the real need of every section than those who live and work in the various regions, it is reasonable to deduce that the primary motive of the so-called federal leadership is essentially political. To paraphrase a quaint saying from the mining country, "Thar's votes in them thar grants."

The states have been by no means free of the political pressures that the relief problem has generated. Various sections of the country have been plagued, from time to time, with different versions of munificent relief plans that are supposed to cure all economic ills. It will be more difficult for the states to resist these demands if the influence of the federal government is to be added to that mustered by the advocates of such spending.

The economic pressure produced by rising living costs can be indicated statistically. This is done in Table IX.

The Bureau of Labor Statistics' index of living costs has been both attacked and defended. Being a single general index or measure, it naturally does not reveal the extremes of living costs of different areas. However, this index as an average, is compared here with an average of

monthly grants which likewise does not reveal the range of the grants entering into the average. It may be conceded that the many welfare directors throughout the country cannot be expected to make the precise adjustments in assistance payments that would correspond with the local changes in living costs. Yet it is interesting, even significant, that, on the average, they should exceed the actual price trend in the degree shown here.

TABLE IX

AVERAGE ASSISTANCE PAYMENTS, COST OF LIVING INDEX, AND PERCENTAGE CHANGES,
SAMPLE MONTHS, 1940-1946 *

	OAA	ADC (family)	AB	BLS Cost of Living index †
<i>Assistance Payments:</i>				
June 1940	\$20.10	\$32.10	\$23.68	100.5
June 1941	21.08	32.73	25.58	104.6
June 1942	21.83	33.74	26.04	116.4
June 1944	27.55	43.08	28.77	125.4
Jan. 1945	28.52	45.68	29.39	127.1
June 1945	29.46	47.46	29.97	129.0
Jan. 1946	31.06	52.62	33.54	129.9
<i>Percentage increases:</i>				
June 1942 over June 1940	8.6	5.1	10.0	15.8
June 1944 over June 1940	37.1	34.2	21.5	24.8
Jan. 1945 over June 1940	41.9	42.3	24.1	26.5
June 1945 over June 1940	46.6	47.9	26.6	28.4
Jan. 1946 over June 1940	54.5	63.9	41.6	29.3

* Sources: Social Security Board, *Social Security Bulletin*, August issues, 1940, 1941, 1942, 1944, 1945, March 1945 and "Advance Release of Statistics of Public Assistance, Jan. 1946" (March 8, 1946), Dept. of Commerce, *Survey of Current Business*, issues of December 1942, the 1942 Supplement, January and December 1945, and April 1946.

† 1935-39=100.

The data in Table VIII suggest a contrast between those features of the assistance problem which are primarily dependent upon changes in economic conditions and those which are relatively independent of such changes. The aid to dependent children and general relief costs illustrate the first case, while old age assistance illustrates the second. The number of relief cases, including dependent children, will rise and fall as business and employment conditions vary. Old age marches on, regardless of economic cycles. The war boom, which was well under way by 1942, created extraordinary employment opportunities, even for the able-bodied aged. Child labor restrictions were somewhat relaxed. It is not surprising, therefore, to find that the numbers of those in all categories who required public assistance declined after 1942.

Nevertheless, the long-run position of the aged in the economy and in the political order is in significant contrast with that of the other

groups. All of the forecasts of the age composition of the future population are in accord in the conclusion that the aged will constitute a larger proportion as time passes. The productive workers and the productive forces therefore face the prospect of an increasing burden of support for this segment of the population. Herein lies the special significance of the tendency to expand the awards to this group.

And here, too, is the point at which natural sympathy is most likely to be at cross purposes with prudent fiscal and economic considerations. It goes against the grain of normal human sympathy to suggest that the aged shall not have decent care in their last years. Yet, as the prospects of the cost of such a program are contemplated, a difficult dilemma is presented. How can such a program be supported without involving costs that will eventually prove to be too great a burden upon the workers, who, as time passes, are destined to be a diminishing proportion of the entire population? The irony of the situation is in the fact that the dice, or rather the ballot boxes, are loaded against the workers, for the one thing that the aged can be depended upon as a unit is to exert their voting influence for larger old age grants.

One answer would be that the current emphasis upon withdrawal of the aged from the labor force should be moderated. The belief that retirement of the "old-timers" makes room and opportunity for younger workers that they would not otherwise have is based on a fallacious "lump of labor" concept, and on an equally fallacious assumption that the economy is static rather than dynamic. Every worker adds to the product and his wage is an addition to total purchasing power. Moreover, the gerontologists have assembled data to show that a sudden cessation of the work habit is quite likely to result in an abrupt termination of the earthly existence. Therefore, if the social purpose is really to see the span of life extended, this can best be accomplished by providing suitable work opportunity rather than retirement, a course which will brighten as well as extend the years, and which will also aid in keeping the costs of old age assistance under control.

It remains to consider a proposal which has been made in recent years with increasing frequency, namely, that the federal share of assistance costs should be variable rather than fixed. The scheme most commonly suggested is a substitute for the 50-50 sharing principle. It is that states with per capita incomes below the national average of income payments should receive a federal grant ranging from 50 per cent to 75 per cent of the total spent, according to the degree of departure of a given state average from the national average. All states with per capita income above the national average should get 50 per cent of their total expenditures. This formula would become the basis of federal reimbursement against total assistance expenditures. The scheme, like the hundreds of others involving federal grants for all sorts of purposes, implies that the

funds obtained from Washington are in some way a net gain. Actually, the states are merely getting their own money back. This can be demonstrated in the case of the formula stated above, which has been advocated as a means of helping the poor states.

The first thing to be noted is that many of the so-called poor states—i.e., those with a per capita income below the national average—are making old age assistance payments approximating or exceeding the national average of such grants. In 1944 there were 32 states with a per capita income below the national average. Seventeen of these states were making old age assistance payments approximating or exceeding the national average. In other words, these states have not yet discovered that they are so poor and so unable to take care of their own relief problems as to require a special increase of the federal contribution.

The second thing that is turned up by an application of the formula to the federal grants and the total expenditures on old age assistance for the fiscal year 1945 is that the formula would have increased the federal share of the total costs as follows:

In 32 states below national average per capita income	\$23,010,000
In 16 states above national average per capita income	21,503,000

The gain to the richer states would have come through federal payment of a full half of their total expenditures. Reducing these increases of the federal share to terms of what each recipient of old age assistance would receive for a given month, the following curious results appear:

TABLE X
INCREASE IN OLD AGE ASSISTANCE GRANT UNDER FORMULA PROVIDING FOR VARIABLE
FEDERAL PARTICIPATION

	<i>Increase per Recipient per Month</i>
32 states with per capita income below national average..	\$1.82
<i>a.</i> 15 states with old age assistance payments below national average of such payments.....	1.60
<i>b.</i> 17 states with old age assistance payments above national average of such payments.....	1.93
16 states with per capita income above national average	1.73

It appears that the group of states with per capita incomes below the national average of income payments, and which are now making old age assistance grants at figures below the national average would receive the smallest benefit from the operation of the formula, namely \$1.60 per recipient per month. The 17 states which are below the average as to income payments but which are nevertheless doing more than the national average in old age grants, would get an increase of \$1.93 per case per month additional. For the entire group of 32 states which would get something more than 50 per cent as reimbursement of their old age assistance expenditures, the average monthly increase per case would be \$1.82.

TABLE XI
EXPENDITURES OF ALL LOCAL GOVERNMENTS FOR CERTAIN YEARS
(MILLIONS OF DOLLARS)

Purposes	1902		1913		1932		1942	
	Counties	Cities & Minor Sub-Div.	Counties	Incorporated Places, 2,500 Pop. and Over	Counties	All Other Local Units*	Counties	All Other Local Units
General govt. Protection	50.3	57.9	102.3	68.9	251.2	.....	249.1	304.3
Health and sanitation	28.5	97.9	15.2	140.7	44.2	.....	57.5	577.6
Highways	1.9	28.6	2.8	60.4	32.8	.....	2.4 †	188.0 †
Charities, hospitals & corrections	28.5	83.6	55.5	87.1	236.4	.....	242.8	395.2
Education	20.4	25.6	37.8	32.9	182.1	.....	510.9 †	488.7 †
Recreation	34.1	185.7	58.0	232.8	182.2	.....	82.0	1,945.1
Miscellaneous	.....	12.5	.4	21.4	7.6	.....	{	{
	2.3	7.3	5.6	22.1	44.8	.....	93.8	325.7
Total current operation	166.0	499.1	277.6	666.3	981.3	3,566.5	1,238.5	4,134.6
Interest	9.6	59.8	17.4	132.3	118.9	612.7	77.6	345.4
Outlays	21.8	184.5	89.8	383.8	311.3	1,164.6	85.0	337.2
Grand total	197.4	743.4	384.8	1,182.4	1,411.5	5,343.8	1,401.1	4,817.2

* Expenditures for current operations not available by purposes.

† Sanitation only

‡ Includes health, hospitals and public welfare

But the 16 states which have income payments per capita above the national average would get \$1.73. As the figures given on page 68 show, these states would receive, on the basis of the 1945 data, within \$1,500,000 as much as would all of the other states. The clue to this result is in the fact that the states which are paying old age assistance grants at levels above the amount at which the federal reimbursement now occurs would gain by having reimbursement for half of their total payments.

Yet the purpose of the formula is, ostensibly, to benefit primarily the "underfed, underclothed, and underpaid" third of the nation. However, it is at least logical that the states which would have to supply the bulk of the funds, if they were to be provided by federal taxation, should get more of their own money back. The completely illogical thing is that any one, anywhere, could be fooled by such tactics.

LOCAL EXPENDITURES

The data for a comparative survey of local expenditures are even more sketchy and incomplete than in the case of the states. The Census Bureau has compiled statistics of local expenditure at intervals but it has not yet solved the knotty problem of securing adequate information from all local units. Table XI is based upon the available materials.

This summary of local expenditures reveals an upward trend that has paralleled the experience of the states. The operation and maintenance of highways is now the largest item of county expense, and highway construction doubtless ranks first among county, as among state, capital outlays. The county has long been an important local unit for prisons and welfare institutions. The high county educational expenditure is due to the fact that in some states the county is the unit of school administration.

There is presented next an analysis of the expenditures of cities with a population of 30,000 and over. The census series for this group of cities was issued from 1904 to 1931, and thereafter discontinued. Some years later data were compiled for the cities of 25,000 population and over, though in a less complete form. The reports published in recent years contain so many gaps as to be entirely worthless for comparison with earlier years. The fragmentary data for 1943 are shown in a separate table.

In Table XII some of the principal subdivisions under the several general governmental departments are shown, with the total and the per capita expenditure. Attention is directed to the rearrangement of certain items, in line with the comments already made on the census classification. Court expenses are treated here as part of the cost of protection, and aid to mothers and veterans is transferred from the miscellaneous to the general welfare group.

While it appears that the growth of expenditures by these cities, of

TABLE XII
ANALYSIS OF TOTAL AND PER CAPITA EXPENDITURES OF THE CITIES
OF 30,000 POPULATION AND OVER

(TOTALS IN THOUSANDS OF DOLLARS; PER CAPITAS IN DOLLARS AND CENTS)

Purpose	Years							
	1904		1915		1924		1931	
	Total	Per Capita	Total	Per Capita	Total	Per Capita	Total	Per Capita
I Operation and maintenance								
General government	22,724	1 05	46,284	1 48	85,134	2 13	128,441	2 66
Protection to life and property (police depts)	42,179	1 96	64,892	2 08	145,170	3 63	228,291	4 73
Fire depts	30,652	1 42	51,754	1 66	117,074	2 93	161,926	3 35
Courts	7,347	0 34	19,173	0 62	35,476	0 88	54,730	1 13
All other	5,615	0 26	10,864	0 35	23,645	0 59	30,838	0 64
Sub-total, Protection	85,791	3 98	146,683	4 71	321,355	8 03	475,785	9 85
Health	4,718	0 22	12,636	0 40	34,206	0 86	54,184	1 12
Sanitation:								
Sewers and sewage disposal	4,533	0 21	7,553	0 24	18,521	0 46	26,401	0 53
Street cleaning	13,281	0 62	36,187	1 16	47,606	1 19	49,551	1 02
Other refuse collection and disposal	5,607	0 26			37,535	0 94	66,121	1 36
Other sanitation	92	0 04	2,907	0 07	4,603	0 11	6,604	0 13
Sub-total, Sanitation	23,513	1 09	45,837	1 47	108,265	2 70	148,317	3 04
Highways:								
Roadways and structures	18,677	0 87	34,216	1 10	71,588	1 80	107,772	2 23
Street lighting	13,633	0 63	23,782	0 76	34,905	0 87	57,079	1 18
All other	4,204	0 20	7,511	0 24	18,557	0 46	16,462	0 30
Sub-total, Highways	36,513	1 69	65,509	2 10	125,051	3 13	181,313	3 71
Charities, hospitals and corrections								
Outdoor poor relief	1,347	0 06	3,811	0 12	9,095	0 22	75,270	1 55
Relief, special classes	2,645	0 12	12,558	0 40	11,664	0 29	26,901	0 55
Other charities	5,909	0 27	2,300	0 08	23,053	0 57	33,868	0 70
General hospitals	4,921	0 23	11,047	0 35	29,695	0 74	52,019	1 07
Other hospitals	1,118	0 05	2,209	0 07	7,015	0 17	19,245	0 39
Corrections	3,079	0 14	7,313	0 23	14,644	0 36	21,554	0 44
Sub-total, C H. & C.	19,116	0 89	39,298	1 26	95,116	2 37	228,856	4 74
Education								
Schools	86,842	4 03	174,039	5 58	541,256	13 53	809,914	16 78
Libraries	4,186	0 19	7,552	0 24	17,769	0 44	29,661	0 61
Sub-total, Education	91,027	4 22	181,591	5 83	559,025	13 97	839,575	17 39
Parks and trees	7,531	0 35	19,161	0 61	29,203	0 73	48,221	1 00
All other	947	0 04	2,228	0 07	17,079	0 42	30,671	0 63
Sub-total, Recreation	8,478	0 39	21,389	0 69	46,282	1 15	78,892	1 63
Miscellaneous								
Retirement pensions	....	.	10,645	0 34	30,592	0 76	68,778	1 42
All other	.		8,336	0 27	24,724	0 61	25,347	0 52
Sub-total, Miscellaneous	5,030	0 23	18,981	0 61	55,316	1 37	944,126	1 94
Total, operation and maintenance, general government	296,924	13 77	578,206	18 55	1,429,750	35 77	2,229,490	46 17
II. Interest	32,193	1 49	128,527	4 12	242,373	6 06	400,349	8 29
III. Outlays (Table VI)	135,664	6 29	258,594	8 30	656,209	16 41	740,077	15 32
IV Public service enter	54,437	2 53	53,823	1 41	139,928	3 50	177,893	3 68
Grand total, All Governmental Cost Payments	519,218	24 08	1,009,150	32 38	2,468,260	61 74	3,547,809	73 46

which there were 310 by 1931, continued unchecked over the whole period, both in the aggregate and in the cost per capita, the details reveal that in some cases the increases occurred more slowly after 1924. The per capita expenditure for street cleaning and for some miscellaneous items actually declined between 1924 and 1931. The number and the importance of such instances are not such, however, as to warrant great optimism over the future of municipal expenditures, unless some effective measures of expenditure control can be introduced.

The most important municipal activities, from the standpoint of operating costs, are education, protection, welfare, highways, industrial enterprises and sanitation, in the order named. With respect to capital expenditures in 1931, the order of relative importance was different, being highways, education, industrial enterprises, and sanitation. The relatively large expenditure for protection is noteworthy. Notwithstanding the large highway capital outlay in this year, the total highway expenditures for all purposes was slightly below the total spent for protection. Between 1924 and 1931 the per capita outlay of the cities for sanitation and highways declined slightly, while in the case of education the decrease was substantial, though not sufficient to prevent some increase in the total per capita expenditure for education, including current and capital purposes, during this period.

TABLE XIII

TOTAL AND PER CAPITA EXPENDITURES OF CITIES WITH A POPULATION OVER 25,000 IN 1943 *
(TOTALS IN THOUSANDS, PER CAPITA IN DOLLARS AND CENTS)

<i>Class of Expenditure</i>	<i>Total</i>	<i>Per capita</i>
I. Operation and maintenance		
General government	\$ 157,393	\$3.02
Public safety	466,056	8.93
Highways	136,008	2.61
Sanitation	138,959	2.66
Health and hospitals	143,763	2.75
Public welfare	209,697	4.02
Corrections	18,956	.36
Education	454,624	8.71
Libraries	28,635	.55
Recreation	68,080	1.30
Miscellaneous	50,915	.98
Total operation and maintenance	\$1,873,086	\$35.89
II. Interest	160,113	3.07
III. Capital outlays	93,246	1.79
<i>Totals</i>	\$2,126,445	\$40.74

* Source: Bureau of the Census, *City Finances*, 1943.

In recent years the Census Bureau has extended its survey of local finances to include cities with a population over 25,000. The current summaries are in abbreviated form and in various respects are not on a basis comparable with the earlier reports. Table XIII presents the data as published for the year 1943.

The most conspicuous lack of comparability with the earlier reports is in the education costs. The present policy is technically correct but quite misleading. The expenditures for education in the above table are for those cities only in which the city administration is directly responsible for the school system. All cities in which there is a management of the school system distinct from the city administration are omitted. Thus, in Indiana, the city school administration is legally identified as a school city, distinct from the municipal city. The subterfuge was adopted as a means of escaping the effects of a constitutional limitation upon city debt. Under this device the municipal city of Indianapolis can borrow to the constitutional limit and the school city of Indianapolis can also borrow to that limit. The bureau's present practice greatly diminishes the worth of the published data, unless these data are to be supplemented by other studies that will include the information now lacking.

CHAPTER VI

Factors and Conditions Contributing to the Increase Of Public Expenditures

THIS CHAPTER deals with some of the factors and conditions that have contributed to the increase of public expenditures in the United States. The summary of the facts of this increase in the preceding chapters has disclosed certain of these influences, but their significance will be found to vary according to the several branches of government, federal, state or local. It is necessary to distinguish, first, certain general conditions that have affected the course of both central and local expenditures; and second, some influences and tendencies that appear to have been especially significant in the federal and the local governmental spheres, respectively.

GENERAL CAUSES OF RISING PUBLIC EXPENDITURES

Two factors that have influenced the aggregate of governmental costs may be passed over briefly, since their effect is natural and obvious. These are, the territorial expansion of the country, and the growth of population.

Territorial expansion. As additions were made to the public domain, the federal government faced the necessity of extending its administrative framework over one large tract after another. The extensions did not cease with the organization of states, for a federal judiciary was still required, as well as the administrative agencies for surveying the land and issuing titles to settlers, collecting the federal revenues, establishing post offices and post roads, and discharging all of the other duties which the constitution imposes on the central government.

Increase of population. Population increase naturally and necessarily compels an increase of aggregate governmental costs, since there are not many opportunities for large-scale handling of individual needs. Every letter or complaint to a public official requires an answer, and receives it eventually. Every suit in the federal or local courts requires the undivided attention of the judge before whom it is tried. Every householder expects to have a paved street or road to his premises, together with a water supply, sewer facilities, street lighting, and a conveniently located school for his children.

As the population increases, and especially with growing congestion in and about metropolitan areas, more things must be done for the people, both individually and collectively. Traffic must be strictly controlled; sanitary and fire prevention measures must be more rigorously enforced; and provision must be made, often at considerable expense, for parks, playgrounds and other recreation centers. Expensive transportation facilities are required, such as express highways, often involving costly bridges or tunnels, as well as subways and other means of rapid transit. A single well may suffice for a town of a thousand population, but a city of a million may need to acquire the water rights of an entire watershed.

Increase of aggregate governmental costs with the growth of population may be, in itself, of minor significance. A more important criterion is the relative rate of increase. If governmental costs per capita are rising, it suggests an increase in the real burden of government. This may be produced by an expansion of the scope of public services, by a more elaborate and expensive standard for these services, old and new, or by defects in governmental organization and procedure that prevent efficient performance of services. Even such a test would not be conclusive, however, for the growth of national wealth and income may be proceeding at a rate still greater than the advance of per capita governmental costs.

Changing price level. A third factor that has affected governmental costs generally is the changing price level. As prices rise, government, like the individual, must pay out more dollars than before to secure the same quantity and quality of goods. Prolonged or severe upward price movements have usually led, eventually, to higher rates of wages, salaries and interest. By the same reasoning, it might be expected that in periods of declining prices, governments would be able to reduce their costs.

Historically viewed, however, governmental costs appear to have been more sensitive to rising than to falling prices. That is, it is easier to find, in a rising price level, an explanation of rising governmental costs, than it is to find, in a period of declining prices, an explanation of lower costs. There has been no substantial experience with declining governmental costs, regardless of the course of general prices.

The comparative inflexibility of the governmental organization and structure accounts, in large degree, for the failure of governmental costs to respond to declining prices. Some items, such as the debt service, cannot be quickly reduced as prices fall. Since sharply declining prices usually lead to diminished business activity and greater insecurity of employment, larger expenditures for relief are required during an extended depression. But there are other classes of expenditure not subject to the conditions just mentioned, and experience indicates that their downward readjustment is not easy. In fact, it is far easier to expand governmental services and expenditures than to contract them, just as it

is easier to swallow a leech than to disgorge it. A vested interest in a government job, office or service can be built up overnight, and individuals and sections that had been perfectly happy before the job or the service had been provided are instantly stirred to rebellion at any subsequent suggestion of retrenchment.

Some instances of reduced expenditures by states and local units were recorded after 1930, when the price index dropped to a level materially below that prevailing prior to the depression. Insofar as these reductions dealt with personnel or with the scope or quality of services, they were achieved only by the most vigorous efforts of organized groups, and in most instances against the strenuous opposition of other groups. The low level of interest rates during the depression years afforded opportunity for reduction of interest costs, when refunding or conversion operations were possible under the terms of bond issues, but many local communities had so completely exhausted their credit resources by excessive borrowing as to be unable to refund successfully. The whole experience of this period would indicate that a drop in governmental costs, during an era of falling prices and as a result of the price decline, is both uncommon and unlikely. Changes in the general price level must be recognized as a factor in the determination of governmental costs, but the increase of public expenditures has been greater than can be explained on the basis of price level changes alone.

The human element. Another factor of no small importance in promoting steadily mounting governmental costs may be characterized as the "human element." It affects the cost of the public business in various ways.

First, there is the influence of various groups which are seeking particular governmental benefits. The term *political pressure group* has been used to describe these organizations and their methods of operation. It may be an organization of contractors demanding more and better roads; or a parent-teacher association urging larger school appropriations; or veterans clamoring for larger payments to or on behalf of ex-soldiers; or a real estate board maneuvering for more street improvements; or an association of public employees seeking pay increases. The number of such organized pressure groups is legion and their points of attack cover, altogether, virtually the whole range of governmental activities. Each one represents only a minority of the electorate, but it is usually well organized, often well financed and always aggressive. Legislative lobbies throng with the representatives of these interested groups, and although any one group can actually influence only a minority of the votes, both legislators and administrators dread open opposition against them as they would dread the plague.

The characteristic philosophy of such groups may be said to be, "live and let live." Each works hard for its particular objective, but it is

ordinarily indifferent to the claims of other groups, except as strategy may call for a temporary pooling or opposition of interests in a campaign. Each group may contain numerous taxpayers, but the particular benefits to be had from success in securing larger expenditures for the favored purpose are evidently deemed amply sufficient to offset any resulting tax increases on the members of the group.

Second, the human element is revealed by the difficulty of securing the close attention of citizens to the public business. The largest taxpayers are often quite as negligent in this respect as are those who are not conscious of paying any taxes at all. Hearings on budgets are always open to the public, but it is quite unusual for anyone to attend unless he is concerned with defending some proposed appropriation against reduction.

In extenuation of this popular attitude, it should be noted that the governmental business has become so complex as to be beyond intelligent criticism, or even understanding, by the rank and file of citizens. Further, public reports are commonly so dull or so meaningless as to provide an effective barrier to better understanding. One test of the fitness for public office that might very well be applied is the ability to present an account of stewardship in a way that would be understandable to the average person. Since some courts have held that the ability to read and write is not a necessary qualification for public office, the day is evidently far off when candidates may reasonably be expected to file, with their notice of candidacy, an attention-compelling essay on the work of the office which they seek and how they would conduct it if elected.

Third, the human element manifests itself in a toleration of low standards in the public service. One aspect of this attitude has been intimated in the preceding paragraph. It is well known that the ablest available men can seldom be elected to important offices, and hence they are not usually nominated. In times of crisis the people may instinctively turn to a great man, but in ordinary elections the candidate whose chief distinction is his ability and fitness too often has little chance against the buffoon, the demagogue, the man who can "put on a good show," no matter how vulgar or bombastic his campaign may be, or how obviously deficient his qualifications may be.

The civil service principle is given lip-service by the federal government and by some states and cities. But at best, civil service has advanced little further, in this country, than the restriction of some of the most flagrant partisan abuses. The victorious party may not turn out the employees under civil service, but assessments upon them for political purposes are not unknown, and it is always possible to confine the scope of the civil service to any desired limits. A large proportion of the thousands of workers employed under the various emergency services by the federal government in its efforts to stem the depression were outside the civil service.

Fourth, the gradual but steady disintegration of the old beliefs and attitudes toward thrift and personal economy has modified the popular conception of governmental economy. Intensive propaganda in favor of installment buying promoted the decline of the older principles of household management, and the transition from a saving to a spending philosophy was hastened by the circulation of various theories and doctrines which purported to demonstrate the benefits, social and individual, of liberal spending. This changed attitude was readily communicated to government. Naturally, if the members of a community have accepted the philosophy of liberal spending in their personal affairs, they will insist upon, or at least tolerate, a similar standard for their government. After the depression began the federal government was subjected to great pressure to spend liberally in every direction, with little regard to the values received in services or goods. Its response to this demand is now well known.

Finally, there is a natural, but nevertheless deplorable human inclination to prefer tangible to intangible evidences of public activity, regardless of the relative cost. For example, every city spends far more on the apparatus of fire fighting than it does on inspection and control of the conditions which cause fires. Fire prevention involves rules, regulations, prohibitions. It means probing of basements and dark corners where inflammable rubbish gathers, stricter building code provisions relative to furnaces, chimneys and electric wiring; condemnation of fire trap buildings. In short, fire prevention is negative—if successful, nothing happens. On the other hand, fire fighting means action, thrill, excitement, from the first alarm and the clamor of rushing fire engines to the five-star newspaper extra, with its clever word-pictures of daring and tragedy. Few realize how much could be saved on fire apparatus by spending a little more on an honest effort at fire prevention.

The spoils system. Another influence that has contributed to high governmental costs everywhere is patronage, the expression of the doctrine that to the victors belong the spoils. This practice is all-pervasive, and no type of governmental unit is free from it. Patronage in appointments has been only moderately curbed by the development of civil service, even in the lower ranks of the public personnel, while in every other aspect of the public business it is subject only to such restraints as conscience may impose. A president's chief source of influence over Congress is his withholding of appointments until his legislative program is enacted. More than one president has seen his prestige wane rapidly after the Congressmen have received their respective allotments of the "plums."

Under the party system it may be conceded that a certain number of the higher, front-office positions must be filled on a political basis. A chief executive of a state or the nation should be permitted to surround

himself with men whose loyalty he can trust and whose service he can command. But any reasonable concession to the proper requirements of party organization can hardly be stretched to cover all of the forms of favoritism that are so common. The abuses of personnel appointment by no means exhaust the catalogue of patronage sins. Concession to sections in roads, post offices and other public improvements; the award of contracts to firms in which the awarding officials are directly or indirectly interested; the deposit of public funds in favored banks; and many other practices of like character abound. All such forms of personal or sectional favoritism are open to the suspicion that they carry an improper advantage to someone, which inevitably means that they are given at the expense of taxpayers in general.

The net cost of patronage has always been a source of unnecessary governmental cost. It is pure waste. Whether such wastes are on the increase relatively to total expenditures, cannot be ascertained, and their influence on the upward movement of public expenditures cannot be definitely measured. Whatever the amount or the proportion of the total, the cost of the patronage system is an unnecessary burden on the people, so far as the proper functioning of government is concerned.

The growth of pressure groups in number and rapacity, together with the unconscionable excesses of the spoils system, provided fertile ground for the seeds of the doctrine that lavish public spending is beneficial to all and harmful to none. Under that doctrine, there is no effective argument against padded payrolls, exorbitant public contracts, or treasury raids for the benefit of special groups.

Defects of governmental organization and procedure. Another condition that has contributed to the increase of public expenditures generally is the maladjustment which tends to develop between the structure and organization of government and the governmental work to be done. This maladjustment is natural, and to some extent inevitable, for the governmental structure is relatively static, while the economic and social order is dynamic. Governmental units, having been once set up, cannot readily change their boundaries, their administrative organization for performing public functions, or the character of their financial resources. Yet the changes in economic methods and in social ideals and standards are constantly imposing new, or at least different, burdens and obligations upon government.

The lag that results from the static nature of the governmental structure has both a beneficial and a detrimental aspect. It is beneficial and advantageous that governmental institutions and procedure have a certain stability, and there would be neither a justification for their continual revision to fit the temporary, often highly variable trends of economic and social conditions, nor an advantage from such effort. It is detrimental in that too great a discrepancy involves relative inefficiency and the im-

position of financial burdens on the people which find no warrant in the scope or quality of the governmental services. Under such circumstances the alternatives are either a thoroughgoing reorganization or the continued toleration of an inadequate and relatively inefficient organization and structure that is expanded from time to time to meet the additional administrative pressure by the creation of numerous excrescent, ill-advised, uncoordinated bureaus and other makeshift devices.

The rapid rise in governmental costs, especially during the past forty years, the phenomenal changes in economic technique during the same time, and the obvious elements in the existing governmental structural situation, appear to provide a strong evidential case against the degree of maladjustment in governmental organization and structure which now prevails. While these facts are quite well and generally known, a brief summary will serve to emphasize them.

Recent technical changes. The tempo of technical change has been relatively rapid since the beginning of the great Industrial Revolution, but it is not too much to say that during the past generation these changes and developments have occurred in directions that have had profound effects on the character of modern society, both in its economic and its general social aspects. They have materially altered the conditions under which the governmental work can be done to the best advantage, for a large part of the governmental service involves contact between public agencies and the people for whom the services are performed. The improvements in transportation and communication are therefore especially significant.

For example, the past forty years have witnessed the mechanical improvement and reduction in cost of the motor vehicle and the well-nigh universal use of this vehicle for both personal and business purposes. The highway network has been greatly extended and highway surfaces have been completely transformed. It is doubtful if there was a single mile of concrete road surface in 1900, outside of a few experiments in city streets. Today there are thousands of miles of concrete highway, and thousands of miles of other types of improved road surfaces.

Within the same period the telephone has likewise become an instrument of universal use and at greatly reduced cost. Daily mail delivery extends into all but the most isolated rural districts. Various automatic communication devices have also been developed, such as the teletype, the news ticker, and more recently the short wave radio. Every city has automatic fire and police alarm systems. The typewriter, the adding machine, the addressograph and various mechanical devices for handling financial and other records are now familiar equipment in every office.

These and similar technical aids that have come into general use have exerted a profound influence upon every aspect of economic activity and of social relations. They have extended enormously the orbit of all busi-

ness relations and they have created a new world for the individual. Their proper utilization should facilitate greatly the operations of government and should secure the performance of the public services at less cost. Public agencies have accepted and are using many of these technical devices, it is true, but under such circumstances that aggregate costs have not ordinarily been reduced thereby. It is not contended here that these costs could have been reduced merely by providing each public office with an automobile, a telephone and a typewriter. The point to be emphasized is that various technical improvements now generally available are capable of serving admirably as aids to more competent administration and that their intelligent application to that end would contribute to substantial reduction of governmental costs. In fact, they open new perspectives with regard to governmental organization.

An excess of governmental agencies. In this new perspective it becomes increasingly clear that there is now an excessive number of governmental agencies. That is, government, in its territorial or external aspect, has developed more administrative units than are now required for competent and economical operation. The actual number of governmental units depends on the definition of a unit. The most recent enumeration is that made by the Bureau of the Census as of 1942.¹

TABLE XIV
NUMBER OF UNITS OF GOVERNMENT IN THE UNITED STATES, 1942

<i>Class</i>	<i>Number</i>
The nation	1
The states	48
Counties	3,050
Incorporated places (cities, villages, etc.)	16,220
Towns and townships	18,919
School districts	108,579
Other units	8,299
<i>Total</i>	155,115

Each of these classes of units within the nation presents great extremes of area, population and resources. Within each class some units are small in area, some in population, and some in financial resources, while many local units are small in all three respects, too small, probably, to be capable of providing services as economically as could be done by somewhat larger units. Criticism of this sort has been directed at some of the states as well as at inferior governmental units, although it has been more voluminous and pointed in the case of the small weak units than in the case of the states. It happens that the states which are small in area, such as Rhode Island and New Jersey, have a considerable population and

¹ United States Census Bureau, *Governmental Finances in the United States, 1942*, p. 115.

substantial resources, while the states with small population have large areas, although not always a large mass of taxable wealth. Again, certain states have both the territory and the population for adequate self-support, but appear to be lacking in the productive capacity and the volume of wealth necessary for the support of proper governmental services. The question of correcting such difficulties by any scheme of state consolidation is so far in the future that it need not be considered here.

Prior to the great changes, mentioned above, that have so greatly extended the radius of travel and communication, the local units of government were necessarily small, for the convenience of the citizens in their contacts with public officials. This was the age of the horse and buggy. Although the principal means of local travel of the last century is now obsolete, the local governmental structure remains unchanged except in scattered instances. It still conforms to the pattern of the horse and buggy period.

This is not, *per se*, a serious indictment. It only becomes so when evidence is produced to show that the small local unit is no longer the most efficient and economical administrative area for functional performance. Such evidence has been and is being produced, however, by various surveys of local government. For example, it is doubtful if a single piece of horse-drawn fire apparatus is now to be found in the United States. Yet it is doubtful if any city has reduced the number and adjusted the distribution of its fire station houses to correspond to the greater travel radius and coverage efficiency of the motorized apparatus.² Public officials, without exception, use the automobile instead of the horse and buggy; yet there is little evidence to show that the automobile has been utilized to extend the effective administrative area. On the contrary, there are about as many small units as ever, except in the case of school districts, and the principal result of the adoption of the automobile by local government has been a large increase in the public investment in motor cars, which are not always used exclusively for the public business. The police use motor vehicles and short wave radio communication, but the municipality, whether large or small, is still the principal unit responsible for police service, although the criminals have complete mobility without regard to city or state boundary lines.

The multiplication of governmental agencies has proceeded vertically as well as horizontally, until in many sections there are numerous layers of these agencies piled one on another. Thus, there is the municipal government, such as a city, town, borough, village or township. Then there is the school district, co-extensive with the county in a few states and

² Cf. The New Jersey Commission to Investigate County and Municipal Taxation and Expenditures, Report No. 4, *Local Fire Protection Services and Costs*, especially pp. 44 ff. (1931).

with the municipality in some other states, but established as an independent entity in still other states. In addition, there may be special districts for all sorts of purposes—roads, water supply, fire protection, sanitation, street lighting, parks, libraries, and various other services. Over all of these is the county, which is an important administrative unit except in the New England states. Around the great masses of population, metropolitan districts have been created for the performance of certain services common to the entire district. Interstate districts have also been established, notably the Port of New York Authority and the Tennessee Valley Authority, to handle matters that extend beyond the boundaries of the states affected. The two interstate districts just mentioned differ radically, however, for the Port of New York Authority is the result of an interstate compact, sanctioned by Congress, while the Tennessee Valley Authority is a federal enterprise superimposed upon the states.

No uniform policy can be discerned in this development of overlapping agencies. In some cases a given service may be split up among several agencies. This is notably true of the police service, and, in less conspicuous degree, of health. In other cases a separate board, commission or bureau has been set up for the administration of a particular activity. Parks, boulevards, recreation facilities, libraries, and hospitals have frequently been thus segregated from the general local administration.

Improper allocation of functions and resources. The maladjustment of governmental organization and structure to the governmental work to be done is evidenced also by the existing distribution of functional responsibilities and financial resources. This situation arises in large degree from the continuance of many small, weak governmental units. The distribution of functional responsibilities between central and local governments is largely traditional or accidental. The local unit has been of great importance, historically, in the development of the American philosophy of government, and it has always enjoyed a large measure of independence and initiative. The early cities and towns took the lead in the development of various public services and they were, in the beginning, without doubt the most appropriate administrative agencies for the purpose. They have jealously clung to these prerogatives, regardless of their size or resources, and regardless, too, of the possibilities of greater economy through functional reallocation as conditions have changed. In consequence, many local units are now struggling under a financial load which is well-nigh insupportable, to carry services that they will not relinquish.

An exaggerated emphasis upon "home rule," or the right of the local unit to manage its local affairs, has contributed to the failure to consider functional reallocation more seriously. The central thesis of this doctrine, properly stated, may be granted, but difficulty arises as soon as any attempt is made to define either a local unit or a local affair. That is,

such a matter as fire protection may be conceded to be a local rather than a state function, in that it can no doubt be managed more satisfactorily and at less cost by some sort of local organization than by the state. But because this is true, it does not follow that each of a dozen small municipalities constituting a single, compact urban area is the most suitable local jurisdiction for the operation of a fire department.³

The determination to retain control of all traditionally local services means that each municipality, whether it be large or small, must have a regulation quota of organization and equipment, including general administration, police, fire, street and other departments, and, except in the few states in which the county is the school district, its own school organization. Especially in the densely populated suburban areas, where many of these small municipalities are crowded closely together, the resulting duplication of overhead and service facilities accounts for large unnecessary expenditure.

The pressure of rising governmental costs, produced in such large measure by the failure to readjust the governmental organization and structure in accordance with the changed conditions, has led to increasing use of aids and subsidies which usually fail to solve the general problem of rising governmental costs. The reason for this is that any system of aids or grants that rests on the existing defects of territorial and structural organization merely adds to the total tax burden. It cannot, in the nature of the case, render inefficient units more efficient, since it has no relation to the sources of their inefficiency. At best, the grant may lessen local taxes in some districts, but its payment tends to perpetuate the small, weak units, and hence the whole scheme of governmental organization which is so heavily responsible for excessive governmental costs.

Diffusion of administrative and financial responsibility. Another aspect of the problem is the diffusion of administrative and financial responsibility. This condition has resulted in part from the duplication and overlap of administrative agencies created to provide services over any particular area, and in part from the internal structural defects of the various types of administrative organization used by these agencies.

The growth and perpetuation of un-coordinated governmental agencies, whether in the central or the local government field, have prevented effective control of both administration and the application of funds. Worse still, they have so obscured the situation as to prevent adequate

³ An illustration is found in Hudson County, New Jersey. Although the entire county is about the same size, in area and population, as the city of Pittsburgh, it contains twelve cities and towns. In 1928 the aggregate cost of fire protection for the twelve municipalities was \$3,800,000. An estimate of the cost of a single county unit fire department, based on the standards of the National Board of Fire Underwriters, was for that year, \$2,094,000. New Jersey Commission to investigate County and Municipal Taxation and Expenditures, Report No. 4, *Local Fire Protection Service and Costs* (1931).

realization of their effects on governmental costs. The various agencies, whether they be independent boards, commissions or bureaus of federal or state government, or the numerous separate overlapping agencies of local government, have been relatively free to make and execute their own several plans. Each seems important, and may be, but there is no way by which relative degrees of importance can be established. Each agency demands, and usually receives, the funds to finance its own program, with little or no regard to the aggregate of such demands on the public revenue. Consequently there can be no comprehensive view of the entire governmental program, nor can there be a comprehensive statement of its cost, except in the final tax bills.

The theory of representative government involves a certain watchfulness on the part of the citizens over their representatives and public servants; but it has proved practically impossible for the average taxpayer, occupied with his personal task of making a living, to watch all of the governmental agencies that are spending his money. This condition has contributed to the growing negligence of the people with respect to the public business. Even if an attempt were made to criticize any particular agency or its expenditure, it is always possible that the responsibility for high taxes may be shifted to other agencies. The county would accuse the city, the city would in turn accuse the school district, and the school district would point to the park board and other special agencies. All are responsible, and yet no one is.

Within each governmental unit, there is a diffusion of responsibility through the spread of executive control over a multiple-headed administration, that is, by the use of a board or commission instead of a single executive. Such a type may work satisfactorily in dealing with fairly simple and limited situations. It cannot produce the best results where large and complicated administrative problems must be handled. Since the several members of an administrative board are equal and coordinate in authority, or in their supposed responsibility to the people or other designating agency, they are naturally inclined to balk at coordination and to resist everything suggestive of subservience to the will or wish of other members. The commission form of city government was hailed as a great advance, and it is now generally employed. As a matter of fact, this was merely the introduction into municipal government of an organization device used in county government from the beginning. It is now realized that there can be as much "log-rolling" in a city commission as in the city council which it replaced. Each commissioner may be in undisputed administrative control over the department assigned to him, but commission budget-making, and more important still, commission budget execution, suffer from the absence of a definite coordinating and controlling authority.

The prevalence of the so-called "long ballot" indicates the extent of

internal administrative diffusion. The greater the number of administrative officials who are directly elected, the greater is the difficulty of bringing public management, both in its financial and its administrative aspects, under that control which is essential to the most economical use of the public funds.

SPECIFIC CAUSES OF RISING EXPENDITURE

Attention must now be turned to some of the more definite influences and tendencies which have been operative in the field of the federal and the local governments, respectively, in bringing about a steady advance in the amount of public expenditure.

The federal expenditures. In the case of the federal expenditures, the most important influence leading to ever higher levels has been the cost of various great emergencies. Throughout the national history, war, including the immediate cost, the expense of caring for veterans, the payment of the war debt, and the preparation for future wars, has been responsible for far the greatest share of the total. To this series of emergencies must now be added the effect of the economic depression which began in 1929, and which was the cause of a greater expansion of the federal expenditure than had ever been experienced to that time under conditions of peace.

The cost of war. The effect of war costs, in the broad sense indicated in the preceding paragraph, is apparent from an examination of Tables I and II. From the beginning of the national government to 1914, the entire expenditure for civil and miscellaneous purposes, plus the postal deficits and the cost of the Indian wards, was but a small part of the total. Except for a brief interlude toward the close of the nineteenth century, the annual expenditure on the army and navy exceeded all civil and miscellaneous costs, but the race for naval supremacy which began then soon put the current armament expenditure in the lead again. How much of this expenditure for military purposes could have been avoided by a different policy of statecraft cannot now be determined nor can one measure the proportion of the cost of the two World Wars which was unnecessary but which was actually incurred by reason of extravagance, by mismanagement of the financial or the military operations, or for other avoidable reasons. Professor Mitchell estimated that the cost of the Civil War was increased by nearly \$600,000,000 by the resort to an inconvertible paper currency.⁴ This was about one-fifth of the total. No authoritative estimate has yet been made of the additional cost of the first World War to the people of the United States on account of credit and currency inflation, or by reason of the manner in which the war preparations and operations were actually conducted. The disclosures

⁴ W. C. Mitchell, *A History of the Greenback* (1903), Ch. X, especially p. 419.

that have been made concerning the finances of the Shipping Board, the Emergency Fleet Corporation and the Veterans' Bureau are suggestive, as are the conclusions of those who have investigated some of the war contracts placed by the government. Professor Bogart suggests that several billions were probably added, in view of the Civil War experience.⁵ It is too soon to have even a suggestion of the effect of financing methods upon the cost of the second World War.

The cost of economic depression. Beginning with 1931, the federal government spent annually for some years enormous sums in an effort to stem the course of the economic depression. This was a new venture, since in all earlier experiences of this sort, a depression was allowed to run its course without extensive efforts by government to check it. The spending program was inspired by the doctrine that the depression movement could be promptly halted and the tide turned toward prosperity by large public expenditures. The first beneficiaries of the policy were banks, railroads, farmers, insurance companies and other debtor interests, and the early expenditures were chiefly in the nature of advances to be repaid. Later the federal government was induced to assume a large share of the cost of unemployment relief. The downward inflexibility of state and local expenditure policy, already noted, prevented prompt and suitable local readjustments to provide for the relief load, and it was passed over to the federal government. The demoralizing effects of such a policy were soon disclosed and later there was a desperate effort to thrust back upon the local units a greater proportion of the actual relief costs, although the federal plan of providing employment through a huge public works program continued.

It has been characteristic of these periods of unusual activity that they have led to an expansion of the administrative organization of the federal government which was never thereafter contracted to anything like the former scale. The governmental organization must expand to provide the machinery for handling a great emergency, but the peculiar fact is that after the emergency has passed some residue of the additional organization always remains, or at least a considerable part of the cost of that organization continues permanently.

The expansion of services. Another specific factor of importance in promoting the growth of federal expenditures is the entrance of the federal government into the field of social welfare, and also into the field of competition with private business. These are developments of comparatively recent date, but their aggregate influence on the federal costs is already substantial and there is every indication that they will increase in importance with time. Already a number of federal departments and bureaus are actively engaged in lines of work looking to the promotion of the general welfare, and there is continuous pressure for further exten-

⁵ E. L. Bogart, *War Costs and Their Financing* (1921), p. 324.

sion of such activities. Old age pensions, unemployment insurance, cheap housing, agricultural aid, and other elements in a so-called "security program" involve future financial commitments for the federal government, the extent of which cannot now be measured.

Federal competition with private business is not a wholly new development, for the postal service has been engaged in such operations for many years. For a few years after the first World War a shipping line was operated, but these vessels were later sold or leased. The craze for inland waterways led to the operation of a federal barge line, while the Treasury has become more and more influential in the control of the banks. But the most striking, and perhaps the most significant manifestation of this development has been the entrance into the power field. The opening wedge for this policy was the failure to dispose of or to utilize the huge power plant at Muscle Shoals.

The utilization of the power plant was bound up with an extensive program for the regeneration of the whole Tennessee Valley basin, but a major objective in this program and in that of the similar projects that have been launched in different sections was the effort to demonstrate the wastefulness of private power production. Reclamation, conservation, flood control and cheap fertilizer are combined with the cheap power objective in these huge undertakings.

State and local expenditure. The principal specific causes of the increased expenditure of state and local governments, aside from the influence of those general factors discussed earlier, have been, first, the expansion in the scope of the services supplied; and second, an advance in the quality, or supposed quality, of these services.

The expansion of state and local services. The growth in the scope of state and local activities has been continuous for more than a century, but the tempo of this growth has been particularly rapid in recent decades. The economic and social changes brought about by the Industrial Revolution and the factory system laid the foundations of this expansion of governmental services. Public education, sanitation, police and fire protection, street lighting and cleaning, the care of defectives, dependents, and delinquents, and other public services that are now regarded as indispensable were either unknown as governmental functions a century ago or were performed in a primitive and relatively inexpensive way. As the transitions from agricultural to industrial activity proceeded, with its accompanying transformation from the rural to the urban mode of life for an ever larger proportion of the people, the tasks devolving upon state and local governments grew, both in diversity and expense of performance.

Much of this expansion has been in the field of welfare services. Detailed statistics for states and cities are available for the last four decades only, but it is within this period that the greatest acceleration of

costs has occurred. In 1902 the primary purposes of peace, order, and security absorbed 26 per cent of all current expenditures; the ratio rose to 28 per cent in 1913, but declined to 13 per cent in 1932, and to 12.6 per cent in 1939, notwithstanding the substantial increase that had occurred in the absolute amounts spent for general administration and protection by the states between 1913 and 1939.

The principal welfare activities of the states in 1902 were education and the care of defectives, dependents, and delinquents. For these purposes the states spent, together, 57 per cent of all operating costs in this year. State participation in the cost of highways, protection and health was negligible. Only two states, New York and Massachusetts, reported expenditures of more than \$1,000,000 each on highways. Conservation of resources was confined to the promotion of agriculture. The small total for interest indicates a modest amount of state debt, and the volume of capital outlay reveals that the period of grandiose public improvements was still in the future.

The situation in state expenditure ten years later, in 1913, was not greatly changed although there had occurred large relative increases of expenditure for some purposes during the decade. These were, however, only the preliminary ground-swell of the huge tide of expenditures that was to come later. Charities and education comprised 60 per cent of all state operating costs. Protective expenditures increased materially but the increase did not greatly alter the proportion devoted to the primary state services.

The twenty-six years from 1913 to 1939 witnessed a tremendous expansion of state expenditures. No state activity was slighted in this growth, although state participation in health, sanitation and recreation was still of relatively minor financial importance. Through this period there was manifest little or no disposition to question the propriety or the necessity of these increases, which elevated the per capita current cost of state government from \$2.52 in 1913 to \$17.76 in 1939.

The growth in operating costs is not the whole story, either, since the payments for interest and capital outlays have likewise risen during this period to unprecedented levels. About 80 per cent of the aggregate capital outlay of the states in recent years has been for roads. The remainder went mainly for buildings for the use of the general administration, institutional care, education, and recreational facilities. Some states have borrowed much more heavily than others for roads and other purposes. Aggregate state indebtedness has been relatively stabilized in amounts since 1932.

In the case of the cities, a similar elaboration of the scope of governmental services has occurred. Despite the relatively larger payments for protection, the current costs of general government and protection together declined, in the whole group, from 36.5 per cent of all current

expenditures in 1904 to 27 per cent in 1931. This ratio is somewhat higher than in the case of the states, but the recent downward trend is similar, indicating in both cases relatively more rapid expansion of the developmental and ameliorative services.

Efforts to secure higher quality of service. Finally, the influence of the effort to achieve a higher quality of public service should be noted, as a factor in rising governmental costs. Personal living standards have risen materially over the last thirty years, and it is but natural that as the standards of individuals rise, their governmental standards should rise also. The man who owns an automobile wants plenty of good roads. The improvements in housing and private office accommodations make people more unwilling to work, or to transact public business in governmental buildings that are cheerless, dingy, lacking in elevator service, and dimly lighted, although many public buildings of a generation ago were as unattractive and as inconvenient as the household furniture of the late Victorian era.

The transition toward higher quality has been dictated in some cases by necessity, in other cases by sentiment. In the early years of highway building, for example, few engineers had what would now be regarded as an adequate vision of the volume, weight and speed of future highway traffic. In consequence, road surfaces have been rebuilt, strengthened and widened; while large sums have been spent on the reduction of grades and the elimination of curves after the original lines had been improved. The railway crossing is obviously the next step that will require further large expenditures in relocation and reconstruction. Government has had no alternative here, but the amount involved has been such as to demand greater attention to standards and to traffic surveys than has been given in the past.

On the other hand, some part of the higher cost of supposedly higher quality of services has been due to various sentimental considerations. Community and even state rivalry in the splendor of public buildings and in the magnificence of their appointments has been highly infectious. Many sins have been committed in the name of civic pride. Some of these improvements are artistic and beautiful, but others are an offense to good taste. In the struggle for higher quality, mere cost is often mistaken for quality, in governmental as in private affairs. Lavish provision has sometimes been made for hospitals or schools or other services, under the impression that the uttermost farthing spent yielded its full quota of higher quality. The efficiency of police or fire protection is judged by the number of men employed and by the investment in motor apparatus and other gadgets. The country was torn with dissension over the rates of wages to be paid under the public works program proposed in 1935. No one seemed to appreciate that whether those so employed should receive current wages or somewhat less really depended on the economic

value and justification of the improvements to be constructed, rather than on any sentimental consideration of relief versus wages.

In the absence of more concrete tests and standards for measuring the economic results of public expenditures, there will always be more or less reliance upon intangible criteria. The development of a technique whereby more dependable, objective standards may be set up and applied is part of the general problem of expenditure control. This problem is dealt with in the next chapter.

CHAPTER VII

The Control of Public Expenditures

THE SURVEY of the factors and conditions contributing to the high cost of government in the preceding chapter suggests the necessity for a better technique of expenditure determination than at present exists. Certainly it warrants raising the question whether the utmost effort has been made to secure governmental services at less cost. Some governmental agencies, and some governmental services appear to be unnecessarily costly, under existing conditions of organization and operation. It is impossible, often, to fix definitely the responsibility for these results, and impossible, therefore, to take effective steps toward their correction. Under such circumstances, the problem of expenditure control acquires significance, both for administrators and for taxpayers.

At the risk of repetition, it must be said that there is no point in seeking to control expenditures if the people have accepted the view that liberal, even lavish spending, is desirable and advantageous. While such a view prevails, conditions which would be disapproved under a policy of prudence because they caused unnecessarily high governmental costs, would be generally approved because they were a means of putting out more purchasing power.

MEANING OF EXPENDITURE CONTROL

As the term *expenditure control* is used here, it means the rational and purposive determination of the amounts to be spent for the public services. Its exercise contemplates a series of changes and adjustments in governmental organization and procedure, to the end that intelligible, defensible reasons can be given for the cost of any particular volume and quality of services. It does not mean interference with the policy of providing services or mere reduction of expenditure, as such, although it does involve the effort to attain optimum conditions of administrative performance, since there can be no adequate defense of governmental organization or procedure that is obviously wasteful. In this sense expenditure control tends toward reduction, but the problem of *control* exists quite apart from the problem of *volume*. Whether the aggregate of public expenditure be large or small, control means that both the adminis-

trators and the taxpayers know why a given quantity and quality of service cost what they do, and that they know, also, how to vary, in either direction, the amount spent.

A comprehensive program of expenditure control obviously requires the full cooperation of the government and the citizens. That is, there are certain steps which require legislative action, or constitutional change, or which devolve upon public administrators and officials. But these changes in governmental organization and procedure, which may be termed the "official" or public aspect of the program, will not suffice alone. Certain responsibilities rest also on the people, individually and in organized groups. These represent the "unofficial" or private aspect of the program. It is clear that both phases of the program must be developed. Perhaps the most difficult part of the whole undertaking relates to that which was characterized in the preceding chapter as the "human element." The popular attitude is a complex, but powerful factor in shaping governmental policy, and it will be largely influential in determining the success or failure of all other devices for expenditure control.

THE PUBLIC OR "OFFICIAL" ASPECT OF EXPENDITURE CONTROL

With respect to the matters involving public law and administration, the achievement of an adequate expenditure control technique requires action along three lines: (1) the organization and structure of governmental agencies; (2) the instruments of expenditure control; and (3) the policy of control.

THE ORGANIZATION AND STRUCTURE OF GOVERNMENTAL AGENCIES

From the standpoint of the organization of the agencies involved, governmental operations may be viewed as a series of acts performed in certain territorial or jurisdictional settings. There are counties, cities, towns and other units, including the states and the federal government, which are performing various services within their respective jurisdictions. The number and variety of local jurisdictions have increased with the years by a process of division. The functions or services performed by each type have not been deliberately planned with a view to the most efficient results, but have been assigned by accident and evolution, influenced by the peculiar circumstances of the national history.

In contrast with local government, where the growth of administrative units has been a process of division, the increase of administrative units at the state and federal levels has occurred by addition. There are only 48 states, but each state has added to its list of departments, com-

missions, bureaus, and boards, thereby producing administrative disorder and increasing the overall cost. So many federal agencies were created during the thirties that coordinators were established, and these eventually became so numerous and so confused as to give rise to coordinators of the coordinators. One step in the readjustment process required for adequate expenditure control is the correction of the jurisdictional and structural maladjustments. It must be emphasized, however, that improvements in organization and structure, while important and essential, are by no means the whole of the program and that comparatively little may be achieved if nothing further is done.

Readjustments in local government. No general prescription can be written that would apply to all local units, everywhere, because of the wide variations in the circumstances and conditions which prevail. The problem has been carefully analyzed for one state, New Jersey, and the suggestions made here are based largely upon that study.¹ Since this state has a tangled and difficult situation, the findings from a study of that situation will be useful as a guide, if not as an exact model, for the sort of readjustment that is generally appropriate.

The findings of the New Jersey study may be summarized as follows:

1. Local units frequently administer certain *basic* services (roads, schools, welfare and health) which in their essential characteristics are not local.
2. Serious maladjustment exists as between truly *local* services and areas. Various devices have been introduced as correctives (e.g., intermunicipal agreements, special districts, consolidation of areas and municipal annexations), but these devices have proved inadequate in their present form and method of operation.
3. Some municipalities have too few governmental responsibilities to warrant their continued existence as separate service units. A proper readjustment of services and areas would decrease the number of such units.
4. As natural service areas widen, the problem of competent and efficient regional government becomes more important.
5. Local governments, left to themselves, have made serious and costly mistakes. Illustrations are the accumulation of elaborate and expensive equipment for services requiring regional treatment; refusal to cooperate with neighboring units in services calling for conjoint action; adding capital improvements without regard to the relation of outlay and service need; and refusing to accede to consolidations and annexations clearly indicated for intelligent adjustment.

The difficulty which is characterized by these findings may be stated, in other words, as a condition in which the factors of self-government, service and tax-paying capacity are out of adjustment—so far out in some cases that public services (the real ends of all government) can be performed only in a cramped, distorted and expensive manner. The solution lies in bringing these factors together. To accomplish this, it is

¹ Cf. Princeton Local Government Survey, *Local Government in New Jersey*, Pocket Report Series No. 3, Princeton, 1937.

necessary, first, to recognize the distinction between the services which are purely local and the other services that are undertaken by local units; and second, to arrange for administration of the non-local services by appropriate jurisdictions.

The following tests are suggested by which to determine the services that are purely local:

1. Matters of policy involved are capable of determination by the community;
2. Operation of the service is within the local administrative capacity;
3. A substantial financial responsibility for the support of the service is within the tax-paying capacity of the local unit,
4. The effect of the service is mainly within the locality and is conditioned by the local environment.

If services do not meet these tests to a substantial degree, under the conditions existing in particular local units, their operation should be transferred to a jurisdiction in which the tests would be met.

The four services which are most likely not to be purely local, for many municipalities, within the terms of the above tests, are roads, schools, welfare and health. These are also the basic services, in that they represent perhaps three-quarters of all expenditures of local governments, and they are also more nearly universal than any other services. That is, wherever people live, these services are required. It does not follow that no municipality, however large, would be an appropriate unit for the operation of these basic services, or that the only remedy is transfer of their administration to the state. The first step in a reallocation of the services which are not purely local is to determine the local units that are not capable of handling them, and for this purpose the following types or classes of units are suggested:

1. Full-service municipalities—those that are capable of administering the basic services in addition to a full range of local services.
2. General service municipalities—those that should operate an adequate range of local services but are not large enough to operate the basic services.
3. Restricted service municipalities—those that do not require the full range of local services and whose authority should be confined to such services as are actually needed.
4. Regulatory areas—those that require no local services.

Obviously, the classification of local governmental units within any state along the lines suggested here would require detailed and intimate knowledge of local conditions. The determination of local need and capacity would involve consideration of such factors as size and density

of population, taxable resources, and the degree of unity and coherence existing in the area as a service unit. It is evident that even the basic services may be "local services," as defined above, in some communities though not in others. The test of the localness of services should not be historic or sentimental—it should be purely pragmatic. Can the community do the job properly and without too great burden upon its resources?

The problem of reallocating services, or of readjusting service areas arises, therefore, principally in the case of the local units which are not entitled to rank as full-service municipalities. In some instances this ranking can be attained by resort to certain devices such as consolidation, annexation or intermunicipal agreements. In a few cases a new regional organization may be required. Consolidation means the merging of two or more local units, or parts thereof, into a single larger unit. All of the combining units lose their identity in the new, larger jurisdiction. Annexation means the taking of one unit, or a part of it, into another. The intermunicipal agreement is one under which two or more local units join together to accomplish a result which each is authorized to obtain independently.

Each of these devices is a means of extending the local service area and of broadening the basis of local financial support. To the extent that any of them may be used, it would tend to provide a jurisdiction that would be more competent to perform local services or to assume responsibility for basic services. Of the three, the intermunicipal agreement faces fewer obstacles than either of the others. Against both consolidation and annexation stand such barriers as pride in local identity, debt adjustments, fear of higher tax rates, vested interests of local officeholders and others, and political pressures more or less obscurely motivated. Arbitrary readjustment of municipal areas by legislative action or other compulsion from above is unwise and likely to produce more harm than good. Every state should have legislation, however, under which local units may proceed, simply and expeditiously, with consolidation or annexation whenever the local impulse is strong enough to surmount the barriers.²

It is not to be inferred from this discussion that bigness in local units is the sole remedy. Large municipalities are not always the best governed or the most efficient as administrative jurisdictions. The real problem of readjustment, as Professor Carpenter puts it, is "the rediscovery of the natural local community which existed in colonial days."³ If this could be done, some natural local communities would be large, others small. Some would require and would be able to provide, services not needed by others. Each should be allotted those services appropriate to its com-

² The best discussion of the subject of readjusting services and areas is to be found in W. S. Carpenter's *Problems in Service Levels* (Princeton, 1940).

³ *Ibid.*, p. 37.

petence and its needs. Once the local governmental structure has been thus clarified and simplified, the extent to which provision must be made for the performance of basic services by some agency other than the local unit will also become clear. Whether that agency should be the state or some form of regional jurisdiction must be determined by circumstances. No valid generalization can be made on this point.

THE INSTRUMENTS OF EXPENDITURE CONTROL

Various matters of procedure that are essential if the character and the cost of the governmental services are to be clearly shown and understood, are here described as the instruments of control. All of these are now accepted as part of the necessary technique of good public administration, and their use is already fairly general. Some of the devices to be mentioned here are dealt with more fully in other chapters, and are therefore discussed here only briefly.

The budget. Every governmental agency authorized to spend public funds should operate under a budget, which means a comprehensive program of expenditures and revenues, prepared and approved in advance of the operations to be conducted under it. The budget should be all-inclusive, with respect to both expenditures and revenues. Its approval is a matter of policy determination, but its execution should be under the manager or other executive head, who should have authority to supervise and control the operating program contemplated in it.

Uniform accounting and auditing. A proper system of accounts is an indispensable feature of public, as of private, business management. So much need not be argued. Whether the accounting methods and terminology should be uniform or not is a matter that lacks general accord. The great advantage of uniformity is in the opportunity thus provided of making comparisons of operating results in different years, and among governmental units for the same year. Since there can be no serious drawbacks to uniform accounting, this advantage should turn the scale.

No argument is required, either, in support of auditing, and the only point to be emphasized is that it should be done by someone who is independent of the officers who keep the accounts, and of the administrative units whose records are being examined. This principle is observed in private business, and in the cases of some local governmental units, through the employment of outside auditing firms.

Central purchasing. Supplies and materials should be bought by a central agency in the case of all governmental units large enough to warrant this procedure. No set limit can be found to mark off the units too small for this practice, but it is encountered, obviously, when the savings of central purchasing are counterbalanced by the additional costs of maintaining a purchasing department.

Personnel selection and training. Employment, like purchasing, should be under centralized management for all departments in all of the larger governmental units. Virtually all government expenditures, except those for the acquisition of land and the improvements thereon, are made either to buy material things or to pay wages and salaries. If it is important to purchase the correct quantities and qualities of materials, it is even more important to select the correct number of properly qualified public employees. The subject of public personnel management must be left to the special treatises, as it is too broad to be dealt with here, even in outline.⁴ The complete application of a good personnel policy in public administration is handicapped by the traditional attitude toward so many public positions, which are viewed as "offices," to be filled by election, rather than as employee positions to be filled by appointment on the basis of fitness. The reconstruction of governmental structure suggested above will tend to correct this defect.

Debt control. The only effective restriction upon the volume of federal and state debt, or upon the purposes for which it is incurred, is that which is voluntarily accepted by the people themselves. With respect to all local governments, however, there should be some reasonable and effective limitation upon the amount and the purposes of local indebtedness. The debt situation of many local governments is an important factor in their current tax burden. It is undoubtedly true that the inefficiency of some of these units as dispensers of governmental services and the improper functional allocation that has hitherto prevailed, have contributed materially to the bad local debt situation. The municipalities, obliged to carry large functional responsibilities for which they are not the best administrative areas, and obliged, also, to finance these services mainly from local tax resources, have had little recourse except to borrow. The readjustments outlined above will lead to a greatly improved relationship between resources and functional responsibilities, and to higher efficiency in the discharge of such duties as may be laid upon any type of governmental unit. Consequently there will be less occasion under such readjustment for the creation of unmanageable local debts than there has been in the past, but this result will not remove entirely the need of limiting and regulating local borrowing.

Financial reporting. This means the delivery of reports, statistical and other pertinent data relative to local finances and financial condition to an appropriate central office,⁵ by which they will be analyzed and from which suitable selections will be made for publication.⁶ Two purposes are involved. One is to provide clear and accurate information regarding governmental operations and their cost, and the other is to assist in formu-

⁴ E. g., L. Wilmerding, *Government by Merit* (1935).

⁵ The State Department of Local Finance. See Chapter VIII.

⁶ Cf. *Public Reporting*, by the National Committee on Municipal Reporting (1931).

lating the desired policy of expenditure control. Among the mass of governmental financial reports now published, it is difficult to find one that is sufficiently clear, simple and reliable to afford to the average person a basis of intelligent judgment regarding the matters with which it deals. A new technique of explaining government finance to the people is required, the basis of which will be the reports gathered from the operating units. These reports will be too technical and involved, in themselves, for general distribution, and will require translation into simple, non-technical language. It hardly need be added that federal and state financial documents and reporting are subject to the same criticism, and should be improved upon in the same way. Despite its importance, the people are likely to be indifferent to what they do not understand.

Thus far it has been proposed to reconstruct the governmental machine so that it will be capable of more efficient operation, and to provide various instruments or devices by which the character and cost of this operation may be definitely known. It now remains to consider the policy of control.

THE POLICY OF EXPENDITURE CONTROL

In the sense intended here, the *policy of expenditure control* means the program of quantity and quality of governmental services to be provided. It means the governmental standard of living, which may be fat, medium or lean, according to circumstances and popular demand. There is such a policy, today, for every governmental unit, but there is no clear and ready means of ascertaining whether it is really fat, medium, or lean. There is frequently so much lost motion and waste effort, under existing maladjustments, that no relation can be established between governmental costs and the service program. Taxpayers may be paying for a fat program, but in reality getting a lean one, by comparison. High expenditures may mean good quality of service, or simply the price paid for the frictional losses of a defective governmental machine.

As stated above, matters of policy are ultimately determined by the people, or by their chosen policy-determining representatives. But in order to render these efforts at policy determination effective, there must be a suitable technique whereby the people may know what various expenditure programs really mean in terms of services, and for a more accurate registration of the popular desire. The only measure now available is that of expenditure aggregates, but this reveals little for either the administrator or the taxpayer concerning the significance of what the government is doing or what the citizens expect.

The achievement of a definite and understandable policy of expenditure control involves the following:

Standards of service and cost. The *standard of service* is a method of expressing the amount and the quality of a governmental service to be

performed. The *standard of cost* is a method of expressing the cost of the service.

The service standard is intended to serve as a means of expressing and describing, definitely and with reasonable exactness, service policies which are at present thought of only in vague, general, indefinite terms. Its development and use involve a certain analysis of each service for the purpose of showing just what kinds of work are being done in providing this service, and how much of each kind. When cost data are also presented, it is possible to show the relationship between the work done and its cost, and thus to provide a basis for intelligent decision as to how much of the service is wanted.

The application of standards may be illustrated in various fields. In the case of education, the quantity and quality of the educational service may be described in different ways. One is the pupil-teacher ratio, which might vary from ten to sixty pupils per teacher. Another is the standard for teacher qualifications which might be a high school diploma or a college degree, with or without teacher training. The curriculum might include only the "three R's," or it might include a vast range of additional subject matter. In addition to teachers, there is the question of school physicians, dentists, and nurses, supervising teachers, social workers for handling difficult delinquent cases and home relationships, and so on. The school budget ordinarily does not show such things, or, if it does, their significance in relation to costs is not adequately emphasized. The issue of school support usually turns on the total appropriation or on the rate of school tax or the size of the state grant to local schools. None of these matters can be intelligently criticized or defended without transferring the argument to the field of the standards set or desired. Instead of asking the community to decide whether the school appropriation should be \$1,000,000 or \$2,000,000, it should be presented with various alternative standards or programs for the educational service, each of which would indicate just what the people would get for a certain expenditure. A low standard would cost, say, \$1,000,000, higher standards would cost more, up to the highest or richest standard which would cost, say, \$2,000,000. The emphasis would then be shifted from the appropriation as such to what the community would get in educational service for a given expenditure. There could thus be an intelligent expression of opinion as to how much of this service was wanted, or how much could be afforded.

Under a system of standards, the people should be offered, for each service, a series of choices. Do they want the benefits of a high standard, or are they willing to accept a low standard? In every case the relationship between what they would get in service and what they must pay in taxes or in some other way is thus made clear. Furthermore, the use of standards provides a definite method of varying the cost. If tax reduction is desired, it involves a revision of the service standard. When a substan-

tial proportion of the community is ready to accept a lower standard for any service, the taxes required for that service can be reduced, but it is absurd to expect both tax reduction and the continued provision of the former high standard of service.

The administrators of every service should learn to discuss their respective activities in terms of standards, and they should teach their constituents to think of it in such terms, rather than in terms of aggregate dollars spent. This is not difficult, for many administrators have at hand the materials for setting out their service operations in terms of standards, and they frequently do much of their own thinking about it along such lines. Nor is it to be supposed that the people would not readily grasp such presentations, for they would be definite and concrete, not abstract. Statement of the governmental business in this form, instead of limiting it to the dry budgetary form now used, would inject vitality and meaning into it.

Reduction of expenditure may be accomplished by the simple expedient of reducing all salaries by such amount as would produce the desired result, but this is obviously the crudest way of securing it. If the former salary scale were reasonable, it puts the teachers or the police force or some other group in the position of contributing to the community, and it subjects the administration to continual pressure from the departments affected to restore the cuts at the earliest possible date. It may be urged that if the effect of reducing the appropriation for any service were set out in this direct way, no reductions of expenditure would ever be made. Whether this be true or not, the statement of the case in terms of standards is the most effective way of assuring clear popular understanding of it and of arriving at definite conclusions as to what quality of service is desired.

Standards of cost are more technical aids, to be derived in the main from the cost data shown in the records of the purchasing department and in the scales of wages and salaries paid. They will reflect also operating efficiencies. Thus, street cleaning might be stated in terms of cents per square yard of pavement surface cleaned, rubbish disposal in terms of cents per ton of material handled, fuel costs in terms of cents per 1,000 cubic feet of space heated, and so on. The quality of the service may be varied by adopting and working toward certain cost standards. The accumulation of cost data as a basis of standards becomes another reason for uniformity of accounting procedure, records and terminology, for comparability of costs can hardly be assured without uniformity of records.

Comprehensive financial planning. Financial planning is necessary to an intelligent policy of expenditure control, for it provides a forecast of future needs, without which sound judgment as to current action is difficult, if not impossible. Planning is especially important with respect to

improvement expenditures, for these usually run to large sums and are frequently financed by means of loans. A five or ten year forecast of a community's needs in the way of buildings, paving, sewer renewals and other large improvements is not always easily laid out, nor is it always possible to achieve great accuracy. But if the forecast is made carefully, it may be modified from time to time, and it will provide a better guide to the determination of what should be spent on each separate undertaking, and whether the time is ripe for making it at all, than can be had if no attempt be made to anticipate future requirements. The proposed new city hall may be deferred, if extensive sewer replacements are known to be imminent, the auditorium project may be abandoned if it is known that extensive borrowing must soon occur for new school buildings, and so on. Planning of future improvements helps a community to put first things first, and to keep its debt within some reasonable proportion to its ability to carry debt service.

Review of expenditure programs or proposals. In the field of local finance, there may be occasions when decisions relative to expenditure and the means of financing expenditure should be subject to review and examination by some higher supervisory authority. This view will be vigorously opposed by all local officials, who naturally believe that municipal officers are always more capable, more honest and less politically minded than state supervisory officers can possibly be. The case does not turn wholly on this issue, for the purpose of such review as should be provided would be simply that of assuring to the people, whether minority or majority groups, an additional means of giving effect to their desires with respect to expenditure policy, or at least of assuring a public hearing and an impartial examination of such evidence as may be available, concerning this policy. The subject touches so closely the topic of state and local financial relationships that further discussion is deferred to the next chapter.

THE "UNOFFICIAL" OR PRIVATE ASPECT OF EXPENDITURE CONTROL

Thus far the program for determining the amounts to be spent for governmental services has dealt primarily with the changes in the organization, structure and procedure of public or governmental agencies. At various points the participation of the people, or that portion of them which constitutes the electorate, has been indicated, particularly with the respect to the determination of governmental policies. Fundamentally, the popular attitude toward expenditure policy is controlling, with respect to the range and character of the services that shall be undertaken, and also with respect to the scale of liberality on which they are supported. Those influences and attitudes that were characterized in the

preceding chapter as the "human element" are powerful factors in shaping the course of public opinion. Thus far this weight has been thrown heavily on the side of expenditure increase, by promoting the expansion of public services and by stimulating disregard of the troublesome question of getting fair value for what is spent.

It will be difficult to establish agencies that can contribute effectively to the molding of a different popular attitude, and to the shaping of a different public policy, but this is clearly the major task, so far as concerns the private aspect of expenditure control. The purpose to be aimed at should not be simply reduced expenditures and hence lowered taxes, per se, but the development of a critical and cautious attitude, and some capacity to look at both sides of a proposal of policy, or as a minimum to recognize that there are at least two sides to most questions of this sort.

Individuals are not usually able to accomplish much, single-handed, although there are instances to show what one person can do through noise, bluster, vituperation and utter disregard of the truth. More constructive and lasting results can be hoped for only through organization. Numerous civic groups already exist, and some have become influential molders of public opinion in this field. The list includes taxpayers' associations, governmental research bureaus, chambers of commerce and other organizations. The name chosen matters little, but certain other things are essential, if such an undertaking is to make a significant and lasting contribution to governmental improvement. These essentials are:

The consistent maintenance of an objective, scientific viewpoint in the approach to all problems of governmental organization, procedure and expenditure. Organizations known to be interested in taxation changes favorable to their sponsors or to other special interests soon lose their influence as critics of public policy, although other organizations seemingly do not suffer impairment of either prestige or influence in continually demanding larger expenditures on behalf of their members. One important rule of the game for governmental research agencies to remember appears to be that increased expenditures may be unblushingly demanded for any purpose without losing face or caste, whereas any suggestion of retrenchment, no matter how constructive the purpose, is likely to mean denunciation as a tool of special interests. It is therefore particularly necessary in dealing with governmental costs, that research agencies should be motivated by rigorous devotion to the scientific spirit in their fact-finding and their conclusions.

The provision of an adequate technique of research. One of the earmarks of competent organization for the constructive and critical examination of governmental problems is the adequacy of the facilities provided for gathering and interpreting data in this field. The preservation of the scientific viewpoint is not easy when the tools of the scientific method are defective or lacking, and the organization that is deficient

in this crucial aspect tends the sooner to degenerate into noise-making propaganda.

This defect is all too common. Invidious comparison is often made between the great progress and achievements in the natural sciences and the halting, uncertain advance of the social sciences, and criticism is often expressed over the failure to keep the social organization up to the pitch of the mechanical improvements. It is said that industrial and technical efficiency, resting on the achievements of the natural sciences, runs far ahead of the capacity for dealing with governmental and social problems.

The gap exists, but this is not surprising, in view of the relative emphasis upon competent research in the two fields, and the relative amounts available for such research. Almost no institution of higher learning, for instance, provides for its departments of economics and politics on a scale at all comparable with the natural sciences, each of which will have one or more buildings, and will be supported amply with funds for equipment, research assistance, and other needs. Progress in improving governmental organization, or in finding the best ways of seeking such improvement, will necessarily be slow as long as the agencies undertaking to deal with such problems, in the universities and elsewhere, continue to be treated as poor relations, seated far below the salt, and grudgingly allowed only moderate, second-rate rations. The physical sciences deserve nourishment and there is intended here no disparagement of their support nor of their remarkable advance; but it is clear that competent, impartial, critical contributions to the improvement of governmental organization and procedure are, by comparison, few, and that an important reason for this deficiency is the relatively inadequate basis for supporting the spade-work required. The absence of dependable information on these subjects leaves the way open, without let or hindrance, for the demagogue and the charlatan, and their impudent disregard of the facts.

Every organization, therefore, which can secure support for the proper kind of research in governmental problems is more than welcome, for it will find a large, relatively unoccupied territory in which to work. No more significant approach can be found than that of the best ways and means of expenditure control, for it goes to the heart of the how and the why of the actual operations of government.

SOME DEVICES TO BE AVOIDED

Expenditure control, as here outlined, evidently involves determination of governmental expenditures on the basis of the best possible conditions of operation and the clearest possible demonstration of the relation between cost and service under these conditions. From this standpoint, certain devices that have been used or suggested cannot be approved, since they aim openly at expenditure reduction without regard to any other

factors or conditions. In short, they are not expenditure control devices at all, but simply expenditure reduction devices of a crude, mechanical sort.

Tax rate limitation. A method of curtailing the expenditures of local government that has been adopted in some states and urged in others, is drastic limitation of property tax rates, either by statute or by constitutional provision.⁷ Many objections could be given, but of these, two only are mentioned:

First, it limits local revenues without regard to the conditions that may be causing heavy taxation. It assumes that high taxes are due to the deliberate negligence or machination of public officials and employees, who can be put in their place only by limiting the tax rate to be levied. Its advocates are ignorant of, or indifferent toward the defective governmental structural and operating conditions that may have been largely contributory to high taxes on property. Indeed, they are not interested in expenditure reduction, but simply in forcing resort to other taxes to replace those now paid on property.⁸ In the nature of the proposal there is nothing to focus attention of the fundamental causes of heavy taxation, nor is there any constructive suggestion looking to their removal. Moreover, the application of this scheme, or its advocacy, has usually preceded careful canvass of other available revenues, assuming that a broader tax base would be an adequate solution of the problem of heavy taxation. The states vary widely in the character of their taxable resources. Those with extensive industrial and commercial activities and a large population are able to derive a larger proportion of all taxes from sources other than the property tax than is possible in the agricultural states. If a state has relatively little else but property to tax, it must rely more heavily on this resource than would be necessary otherwise.

Second, within any state the scheme ignores the local variations in property tax rates. Owing to the wide differences that exist between the burden of services carried and the taxable resources of the several districts, in any state, tax rates vary greatly even when property assessments are fairly uniform. State-wide imposition of a maximum tax rate means either a rate sufficiently high to permit continuance of the existing scale of expenditure in many districts, or else a rate so low as to prevent maintenance of essential services, even with the aid of additional taxes, in other districts.

⁷ Cf. *Tax Rate Limitation*, published by the Public Administration Clearing House (1934).

⁸ E. g., the indefensible proposal of the National Association of Real Estate Boards that no state should obtain more than fifty per cent of all taxes from real property. The same proposition is being stated by various persons in the converse form to the effect that every state should plan to obtain at least half of the state and local revenues from income taxation. The discussion in Chapters XXIII and XXIV indicate how difficult this would be for some states.

Aggregate expenditure limitation. This method, under which total expenditures are limited, usually with a moderate percentage increase permitted in each successive year, also ignores all reasons for existing governmental costs, and, like tax rate limitation, does nothing to direct attention or remedial action toward the fundamental causes of such a situation. It accomplishes nothing eventually for expenditure reduction, for the operation of even an annual permissive increase of 5 per cent would result in doubling expenditures in about 18 years. As applied in Oregon, temporary economies are discouraged, since the expenditure in any year becomes the basis for measuring the 6 per cent increase allowed in the following year. The California plan does not have this feature, but both plans obviously ignore the difference in rates of community growth. Stationary or declining populations in some districts might result in no effective limitation under the permissive annual increase, while rapidly growing communities would be unable to provide adequately for necessary services under such a restriction.

Salary and wage cuts. Horizontal salary cuts were made quite generally during the depression years after 1930. Readjustment of rates of pay when prices and other incomes are falling is reasonable enough, but it is not an adequate solution of the problem of high governmental costs. The reductions effected after 1930 were recognized to be temporary, and were to be restored as soon as conditions warranted, if not earlier.

Enough has been said to make it clear that the problem of high governmental costs cannot be adequately and effectively dealt with by any mechanical, self-operating device. This problem involves the most vital aspects of the governmental structure and methods, and can be properly solved only by an attack which penetrates to these vitals.

The program outlined here may be justly criticised as being too elaborate and too difficult to install speedily, to serve as a suitable approach to this question. The justice of such objection is recognized and admitted. But it must be remembered that the governmental situation involved is itself elaborate and complicated. If there be any simple procedure by which the whole series of complications can be readily resolved, it should by all means be accepted. Since the causes of the high governmental cost are the product of a long period of haphazard development, it seems more reasonable to assume that their correction will require a patient, careful taking down and rebuilding. Greater concern should perhaps be felt, lest the impetuosity of the American people should lead them into making wholesale, sweeping changes in the effort to secure lower taxes, without due regard to some essential elements in the problem. The acceptance of tax rate limitation and the indifference it has engendered toward the real problem are illustrations of what can happen when action is precipitated without the guidance of reason.

CHAPTER VIII

Central and Local Administrative and Financial Relationships

THE SURVEY of public expenditures to this point has dealt with the recent trends, some causes of the increase, and some suggestions looking toward more intelligent determination of the amounts to be spent. Throughout, it has been assumed that the primary purpose of government, the essential reason for its existence, is the performance of the services required for the protection, comfort and well-being of the people. It has also been assumed that these services should be provided in the most economical and efficient manner possible. Another aspect of this general problem of efficiency and economy in governmental operations is presented by the relationship to be established between central and local units in supplying services and providing funds.

THE PROBLEM OF CENTRAL AND LOCAL ADMINISTRATIVE RELATIONSHIP

Considered directly and without regard to complicating circumstances, the question of central and local administrative and financial relationships may be fairly definitely stated. It is a problem, first, of the proper location of administrative responsibility for services so as to secure the best results in the planning for and the operation of each service; second, of the proper location of the responsibility for obtaining the funds required to support all of the services undertaken; and third, of the proper coördination of actual administration with financial support, in those cases in which the best administrative jurisdiction and the best fund-raising jurisdiction are not the same.

The whole problem of central and local relationship thus reduces itself to three clear but difficult issues: Where is the most efficient administrative jurisdiction for each service? Where is the most efficient administrative jurisdiction for each kind of tax? How adjust administrative and financial burdens when the two kinds of efficiencies do not occur in the same jurisdiction?

These issues are not coördinate. The location of the superior administrative efficiency for each service is the most important of all. In fact,

it is the key to the entire tangle of high costs and heavy taxes. Greater tax efficiency and smoother adjustments through grants and subsidies will simply mean greater overheating of the taxation and expenditure engine, unless the frictional and other wastes can be kept down by improvements in service administration. Raising the money and apportioning it are both minor to the fundamental problem of allocating each governmental function to that jurisdiction in which it can be performed most efficiently and most economically.

Under the circumstances actually existing in any country, the matter cannot be dealt with as directly as is here implied. Existing governmental institutions and the influence of historical precedent are complicating circumstances that must be reckoned with. The distribution of functions between central and local agencies in different nations is not determined in all cases by relative central or local efficiency of administration or taxation, but by the historical conditions and forces that have shaped the growth of the governmental structure. The administrative centralization that prevailed in France under the old régime left a permanent impression, and the proportion of the total expenditure made by the local governments has been relatively small. On the other hand, the greater measure of local freedom and authority that existed in England and the United States has resulted in a relatively larger sphere of local activity. Bastable suggests that historical conditions are the result of still deeper forces, such as the physical features of a country or the character and sentiments of its people. The contrast between the New England town and the southern county resulted no less from the widely different environmental conditions than from the social and political theories held by the northern and southern colonists.

It is never possible to unscramble the omelet made by history, or by history and geography together, not even with the alchemy of revolution. The best that can be hoped for is evolutionary change, achieved by continuous pressure for a program. In this discussion the three aspects of central and local relationship mentioned at the beginning of the chapter will be briefly applied, first with respect to the federal government and the states, and second, in the case of the state and its subdivisions. For convenience these will be designated, respectively, as the administrative, the revenue and the grant relationships.

FEDERAL AND STATE RELATIONSHIPS

The federal and state administrative relationship. The adjustment of administrative and financial responsibilities between central and local units is complicated, in the United States, as in all countries having a federal type of government, by the restrictions placed on the various units in the Constitution or pact under which the federation exists. The

United States Constitution limits the federal administrative authority to those subjects set out therein, with such additional implied powers as may be necessary to give proper effect to the delegated powers. All other authority is reserved to the states or to the people.

Readjustment of this functional distribution may be secured directly by amendment, or indirectly by differences of interpretation. Strict or liberal construction of the delegated and implied federal powers makes a considerable difference in the sum total. During the national history the interpretation has varied according to the motives and viewpoints, political and economic, of the successive dominant groups. The early national leaders were federalists, believing in a strong central government and taking a liberal view of the scope of federal powers. During the first half of the nineteenth century the strict constructionists were in the ascendancy, and since the Civil War there has been a return swing of the political pendulum toward greater federal power.

The expansion of federal administrative authority has proceeded at an accelerating tempo, especially during the past forty years. Each major political party, when in power, has pushed the federal administrative boundary farther outward. The ostensible justification has been the emergence and growth of economic and social problems that extended beyond the jurisdiction and powers of the states. The existence of such problems is of course obvious; but there is more than this to the movement, however, for neither major party has been willing to restrict its federal policies to the truly national or interstate aspects of economic and social problems. Both have been willing to encroach steadily upon the states in their domestic or local affairs. There is in these developments something of the itch for power that has characterized recent political developments elsewhere.

Federal powers have been expanded in various ways. The Sixteenth Amendment broadened the federal taxing power, and the Eighteenth Amendment, while it lasted, gave tremendous authority over the sumptuary habits of the people. A steady expansion has occurred also through legislative action, sustained in part by judicial construction.¹ Finally, it has been achieved by purchase, as it were, under a system of liberal grants to the states.

Throughout the national history the basic issues that should control and determine the distribution of administrative responsibilities between the federal government and the states commonly received too little attention, since the fundamental question of whether the federal government or the states is actually the better agency for performing any particular service was not, and often could not be, considered. If the Constitution

¹ Cf. W. W. Thompson, *Federal Centralization* (1923). The Supreme Court is now in process of checking some of the recent attempts to legislate in forbidden constitutional territory.

delegates the task in question to the federal government, the states have no authority to act; but if the subject in question is reserved to the states, their delay or diversity of procedure may tempt the federal government to intervene, although the absence of clear constitutional power and jurisdiction has sometimes compelled resort to devious, and occasionally dubious methods. Hence, neither government has ever really been free to discover, experimentally, what things it could do more efficiently than the other.

Despite the lack of experimental data, it is possible that the country may be persuaded, or forced, to consider a reallocation of internal functional responsibilities. If so, it must be accomplished largely *a priori*. So far as a problem of such great difficulty can be solved in this way, the effort should be made to establish the new distribution of powers according to the probable relative administrative efficiency of each branch of government. This is the fundamental issue, which must not be obscured by any illusions carried over from the era of "easy money," or any preconceptions based on the collapse of state initiative under the impact of federal financial aid. The central question must be: What things can the federal government do, for the common good, better than the states can do them?

No concern need be felt, in facing this question, that the correct answer would always favor the federal government, for it has been abundantly established, both in private and in public administration, that a unit too large for the purpose can be quite as wasteful and uneconomical as one that is too small. The taxpayers' burdens would be even heavier if all administration were centralized in Washington than they would be if it were all relegated to the municipalities. In short, there would unquestionably be an overwhelming case for the existence of intermediate governmental units such as the states.

The proposition hardly needs argument or demonstration. Another question, and one which is of the utmost long-run significance, although this is not always fully appreciated, must also be decided. It is whether to accept the logical conclusion of the present tendency, which is to demote the states to the position of provinces, largely dependent upon central funds and regulations in performing such services as may be assigned to them, or to restore their morale, prestige and self-respect by recognizing and observing their rights and responsibilities within the sphere of duties assigned to them.

With respect to internal affairs, the only field in which the question of the distribution of powers arises, since the federal government is necessarily and naturally supreme in foreign affairs, the most obvious solution would appear to be that of assigning matters of general concern to the federal government, and those of state and local concern to the states. The application of this formula would be difficult, since the views

as to what is general or local will vary widely. The truth is that in many service functions there is both a general and a local aspect or element, and that the allocation cannot be properly made until the traditional functional forms have been broken up into new and different functional categories.

The federal and state revenue relationship. Under an ideal relationship between federal and state governments, the comparative efficiency in tax administration would determine the allocation of revenue administrative responsibilities. This ideal is no more possible of realization with respect to revenue administration than it is in the case of functional administration in general. In both cases the advance must be in the nature of a slow process of correcting the mistakes that were made because of hasty, impatient action in dealing with real, or supposed, emergencies.

Prior to the great changes wrought by the first World War, there was comparatively little friction over revenues. Federal, state and local units were able, on the whole, to operate comfortably within certain traditionally established revenue systems, without competing against each other for new tax sources.

The present situation is quite the reverse. The tremendous increase of expenditures has caused all grades of government to exploit to the utmost every possible form of taxation. Federal and state governments are taxing incomes, and transfers at death, and also tobacco, liquors, and other commodities.

The friction produced by this overloading of the taxpaying capacity of the country has produced a state of mind not conducive to the satisfactory settlement of some of the difficult matters of tax comity. The states are seeking to organize sentiment favorable to certain adjustments whereby they may increase their own revenues. Their desire to participate more adequately in certain taxes now virtually monopolized by the federal government, notably income and death taxes, can be appreciated. On the other hand, the federal government's need for continued heavy taxation in order to support the huge indebtedness which it now carries, is imperative. Neither federal nor state governments are interested in, nor concerned with expenditure reduction as a prerequisite to finding a solution to the present maladjustments in taxation.

The huge returns from some federal taxes have created an impression that the federal tax administration is superior to that of the states. There is an advantage in some cases, but the reasons for huge federal tax receipts are often to be found elsewhere than in its administrative competency. Since this whole subject touches so closely the topic of tax administration, further discussion of it is deferred to that point.²

Federal and state grant relationships. The third angle of the problem involving the relationships of different governmental units relates to the

² Cf. Chapter XIX.

adjustments required when there is an unbalance between the volume of administrative responsibilities and fund-gathering resources. It is useless to speculate on what this relationship would be between federal and state governments if the other aspects of the problem were to be completely worked out between them. Under present conditions the federal government has been supplying the states with funds for various purposes.

The federal grant policy dates to the early history of the Union, when public lands were given for schools, roads and other purposes. It was never entirely abandoned, even during the period of reaction against federal aid, and it was renewed on a greater scale than ever with the inauguration of the modern highway grants. There was some doubt at first, of the constitutional authority of Congress to make grants to the states and various subterfuges were used. Federal aid in building the interstate trunk highway network was extended under the power to establish post offices and post roads.³

The first grants in aid of forest fire prevention were limited to forests covering the watersheds of navigable streams, to avoid the constitutional issue, but Congress presently became bolder, as one writer puts it, that is, more indifferent to the constitutional issue, and later gave such grants for any publicly or privately owned lands.

It is impossible to arrive at sound judgments concerning a federal grant policy during the prevalence of "state mendicancy," as Professor Ford has called it, and while the federal funds granted are obtained, not through taxation, but through inflationary devices. If all federal funds were to be obtained through taxation, the illusion of federal fiscal superiority would be quickly shattered, and the states and cities would discover that they were able to administer and finance their activities to a degree which they would be unwilling to admit, while the funds come from nobody's pocket. The adjustments in administrative and financial relationships that would be made in an atmosphere of sober reality would be far more dependable than any arrived at during a régime of unsound financial methods.

The cost of the second World War and the huge federal debt that was piled up under the financing methods employed raise serious questions for the future of federal-state fiscal relationships. The prospect for the post-war federal budget is such, even under the most optimistic views regarding its reduction, as to demand critical examination of the policy of further federal aid to the states and cities. It is no longer sensible to pursue a policy of liberal grants to these units such as could have been tolerated—and borne—when the federal requirements were much less than

³ The highway act of 1916 was entitled: "An Act to provide that the United States shall aid the states in the construction of rural post roads, and for other purposes." A rural post road was defined to be any public road over which the United States mails are or hereafter may be carried.

they will be henceforth. To obtain funds for such purposes through taxation, federal taxes must be pushed to levels that are likely to impair the vigorous functioning of the whole economy. Insofar as this result ensues, the whole purpose of the grant program is defeated. To obtain the funds through a further increase of the public debt will involve all the dangers that lurk in an expanding debt—inflation, eventual repudiation, and fiscal demoralization.

Moreover, the war prosperity, artificial as it was, benefited the states and cities by causing their taxes to produce abundantly without increase of rates. They have been able to reduce their debt and to accumulate cash surpluses. They are no longer in the dire straits that plagued them during the 1930's. With good management, and under a national policy designed to provide the conditions favorable to sustained production and employment, no good reason will exist for a continuance of large-scale federal grants.⁴

STATE AND LOCAL ADMINISTRATIVE AND FINANCIAL RELATIONSHIPS

The adjustment of administrative and financial relationships between the state and its local subdivisions in order to provide governmental services most effectively and under the most equitable conditions of taxation involves problems and procedure similar to those already outlined for the federal-state relationship. So far as concerns functional allocation and the rearrangement of governmental units in order to provide the best operating conditions in the performance of the various services, these problems, in the field of local government, have been dealt with at some length in the preceding chapter. It is necessary here to consider principally the financial relationship between the state and its subdivisions in supplying and controlling the use of the funds for actual administration.

It should be as clear in the state-local field as in the federal-state field, that some kind of local unit or units is required, for the most efficient administrative results. All services cannot be centralized into state control, nor can they all be relegated to local control, without incurring far greater wastes than at present. Those which are to be performed by some type or other of local unit, whether city, county or regional district, fall into three groups, namely: services financed wholly by the state, although administered locally; services financed and administered wholly by the local unit; and services financed jointly by local taxation and state aids, but administered locally. The problem of grants arises only in connection with the last group of services.

⁴ Cf. The Committee on Postwar Tax Policy, *A Tax Program for a Solvent America*, New York, 1945, pp. 208, 209. This group recommended a careful review of the whole federal subsidy policy and the elimination of all grants if their retention would endanger the goal of federal budget balance.

State grants-in-aid. The term *grant-in-aid* comes from the English practice, and it means, literally, a grant from the central treasury in aid of the performance of a service by a local authority. It is not strictly accurate to speak of funds paid by the state to finance wholly a service administered by its inferior units as a grant. The local unit is acting, in such a case, simply as an administrative agent for the state, and the state's payments to it are either an advance, or a reimbursement of funds. It is convenient, however, to consider this alternative situation here.

Although actual illustrations of this situation are rare, it is by no means an impossible or unusual one, under any rational allocation of service responsibilities made with a view to securing the best operating results. For example, it is entirely possible that highway maintenance will prove to require, in most states, an operating jurisdiction smaller than the state but larger than the present small road district. If the jurisdiction selected for maintenance purposes happens to be a local governmental unit, and this is entirely possible, the above condition is met. Under such an arrangement the state highway department would establish the standards of maintenance to be followed for the different types of road in the district; the funds to be spent could either be allotted on the basis of the standards set, or better still, budgeted by the district. Expenditure would proceed under the direction of the district's highway engineer, and after inspection of the results by the state department, reimbursement could be arranged at quarterly or other convenient intervals.

Old age pensions and outdoor poor relief may be mentioned as other services that may prove to be most effectively handled in similar manner. The present tendency is to regard these services as financial obligations of the state, in order to minimize the troublesome problem of local domicile, and to avoid excessive inequalities of the local relief load. Again, the appropriate state department would set the standards, or the maximum and minimum limits of such standards, and the actual dispensing of relief for the aged and other dependents would be managed by local units, subject to state inspection and supervision.

Joint state and local financing. The problem of state grants, in the correct sense of the term, arises in the case of services to be financed jointly from state and local sources, but administered by some local unit. The disparity between local resources and the burden of local administrative responsibilities has already been recognized, and in every state some kind of local distribution scheme is found for aiding certain locally administered services. These schemes are generally defective in that they have been inaugurated without an attempt to reconstruct the basis of local administration, although the costliness of the defective local structure has played an important part in producing the excess load. In consequence, the funds allotted to local use from the state are in some degree a payment in support of the inefficiency of the local structure, rather than

in support of a better quality of service. The first essential is the assignment of the administrative responsibilities of service operation to units adequate for their satisfactory performance. Only after this has been done will the state grants serve most completely and effectively their object of improving the service and equalizing the tax load.

The conflicting interests in state legislatures have been singularly blind to this fact. The rural members and the whole rural population, for example, have been comparatively indifferent to the conditions making for relative administrative inefficiency in the urban centers. Their attention has been fixed upon the operation of the system of state grants in rural districts, and if reduction of rural property taxes is achieved, they are satisfied. In fact, the volume of state revenue available for aid in rural districts is materially affected by the local administrative costs in the cities. If these are abnormal on account of maladjustments in jurisdiction, structure, or functional allocation, urban taxes will be high, and they will have strong claim for state support. The greater the proportion of the funds that is absorbed in aid to the cities, the less there will be available for the rural districts. Needless to say, the urban element is just as blind to the consequences of similar maladjustments in rural governmental organization. In other words, taxpayers everywhere are singularly indifferent to the amount of taxes consumed by the lost motion of a defective governmental machine, and they cling pathetically to the belief that a system of state aids will correct all such difficulties.

The fundamental changes in local governmental organization, structure and procedure that were mentioned in the last chapter will not obviate the need of state contribution toward the support of certain services, since there will necessarily be, after such changes, marked diversity in local taxable resources within the several districts. The distribution of taxable property, for example, does not coördinate well with population, or with geographical area or with the cost of performing governmental services. The basic purposes of a system of state grants, then as now, should be, first, recognition of the element of state-wide importance of the service, and second, equalization of the local tax burden of supporting it.

This discussion must be limited to the technique of distributing the amount of aid decided upon, and cannot be extended to include such questions as the proper amount of aid or the services to be thus supported. These are matters of policy which must be decided eventually, in every state, by the people themselves. But it is apparent that the amount of aid to be given is conditioned upon the productivity of state-administered taxes and upon the extent to which it is decided to provide local tax relief, which means, practically speaking, reduction of the property tax, for this is and no doubt will continue to be the chief source of local revenue.

The essentials of an aid program involve the following steps: first, determination of a minimum acceptable standard for the service; second, determination of the amount available in each district from the taxation of the equalized assessment of taxable wealth at an assumed rate to be levied uniformly in all taxing districts; third, payment by the state of the difference between the yield of the local tax and the cost of the minimum standard established.⁵

Each element in this procedure is flexible. The minimum standard is that standard toward the maintenance of which state aid will be provided, and it may be set relatively high or low. For example, in the case of education, it would normally be stated in terms of dollars per pupil, and the amount may be such as to provide one type of curriculum and school training or another. The amount of the local contribution toward this standard may also be varied according to the local tax rate assumed. In order to measure each district's local share properly, effective methods of arriving at equitable assessments of taxable property are assumed, but this subject belongs in the field of tax administration.⁶ The tax rate assumed in calculating the local contribution should be uniform throughout the state, since one purpose of the grant is to eliminate unequal local taxation for the support of the service aided. Finally, by varying the minimum standard and the local tax rate, the aggregate of the state's contribution may also be varied.

It should be noted that the grant is to be applicable only toward meeting the cost of a certain reasonable standard for the service, and for equalizing local taxes to this end. If any district should desire to provide a higher standard, and to levy additional local taxes for this purpose, there could be no objection. This policy naturally should not deprive it of such advantage as the aid system might afford, within the limits of the uniform standard and the uniform local tax rate.

STATE SUPERVISION OF LOCAL FINANCES

The grants to aid local units in the performance of important services which they rather than the state should administer for reasons of efficiency do not embrace, however, the whole duty of the state with respect to the financial affairs and operations of its subdivisions. There must be a general supervisory relationship that covers all aspects of local finance.⁷

The need of state supervision of all aspects of local administration is clear, although it has been recognized, and the facilities for exercising it

⁵ This method has been adopted in several states for the distribution of school aids. See P. R. Mort, *Report to the Governor's Commission on Education in New Jersey* (1933).

⁶ Cf. Chapter XIX.

⁷ Cf. H. H. Lutz, "State Supervision of Local Finance," *Journal of Political Economy*, June, 1935, Vol. XLIII, pp. 289-305.

have been developed more fully, in the case of education than of any other local function. This discussion is limited to the field of finance, but the general nature and principles of supervision appear to be much the same wherever applied.

It must be emphasized at the outset that the supervisory relationship can exist only when the primary responsibility for administration rests on a local official or employee. If the state is actually the authority responsible for the service, the control that state officers may exercise over their local agents is quite different in nature from that which is implied under supervision.

The purposes and objectives of supervision, in the sense intended here, are the following: first, to establish, or to aid in establishing, standards of service, rules of procedure, and the goals to be achieved through the performance of the activity or operation; second, to guide, educate, and otherwise assist local officials in complying with the standards established, third, to inspect the results and to take such steps as may be necessary in order to assure proper observance of the standards, regulations or procedure laid out.

These three steps or stages are all important and necessary. The first stage is already generally recognized, for the rights, powers and duties of local governments are determined by state legislation, and in some instances by the state constitution. Thus the standards and goals of local administration are in large measure a matter of legislative action. The absence of appropriate agencies for the performance of guidance and supervision, the second and third steps in the supervisory process, has frequently impelled legislatures to enact more drastic statutes than would otherwise be required, in an effort to achieve through legislative stringency the results that effective supervision would have assured with less friction. There has been much complaint among local officials over so-called "mandatory legislation" which is frequently the legislative way of seeking to make up, by strict statutory control, for its neglect of proper supervisory machinery.

In the field of finance, the whole sweep of local responsibilities and activities is naturally divisible into two parts, namely, the administration of the important local revenues, chief of which is the property tax, and all other aspects of financial administration, such as budgeting, accounting and auditing, borrowing and purchasing. This division is a matter of convenience rather than a logical necessity. It is generally recognized that the local operation of the property tax requires the supervision of a central authority; and in virtually every state a tax department or similar agency exercises more or less supervision over the assessments, and in a few cases, over the collections, under this tax. On the other hand, some states have set up supervision over one or more phases of local financial administration, and have established fairly comprehensive supervision.

The supervising agency. Every state should provide a supervising agency to have charge of all other aspects of local finance, in a manner similar to the supervision now exercised by tax commissions over the assessment of property. The various incomplete schemes of such supervision, now found in different states, whereunder the tax commission, or the state auditor, or the treasurer or some other state official, has some degree of oversight over auditing or accounting or borrowing or some other financial operation, should be in every case broadened and perfected by providing a new state agency designed and organized for the express purpose of supervising all important aspects of local finance. An appropriate title for this new agency would be "State Department of Local Finance." Tax collections could, with propriety, be placed either under this department or under the tax commission, but there can be no question of the need of central supervision over this activity.

However excellent the state reorganization codes may have been, from the standpoint of the general improvement in administrative structure effected under them, they have been uniformly deficient at this point, for none of them has provided a department of local finance, although the problem of adequate and effective relationship in financial matters between the state and its local units obviously existed at the time these codes were being written. This is evidenced by the makeshift arrangements for supervision of some, but not all such activities that have been developed.

The supervision process. The following outline of the functions of a department of local finance is intended to be illustrative of the manner in which such a department should organize its procedure. It will serve to apply the general purposes or objectives of supervision, as set out above, in this particular field.

Standards. The first step in supervision is the establishment of standards. With respect to budgeting, accounting and auditing, the statutory standards should be general rather than specific. The state department should apply these standards by setting up flexible requirements appropriate to the variable local conditions. In each case the method would be to prescribe a skeleton form of procedure, embodying the essential principles, and then to allow local adaptation by varying the amount of detail. The budget of the smallest and that of the largest community in the state would be alike in their observance of certain general principles, but one would be simple, the other elaborate, by reason of the differences in the details to be shown.

In the case of local borrowing, some sort of statutory standard, in the nature of a limitation on the maximum indebtedness, appears to be necessary, but it has not been easy or satisfactory to regulate local borrowing by any sort of constitutional or statutory formula alone. The department of local finance should have some discretion in the interpreta-

tion and application of this standard. Under certain obvious emergency conditions, it might be empowered to authorize borrowing in excess of the formal limit. Within this limit, however, there is much that it could do through the erection of auxiliary standards. It could accumulate data for the determination of the reasonable life of improvements to be financed by borrowing; it could study the experience of different communities with debt payment, and develop methods for determining safe debt maxima within the overall debt limits, based on the records achieved; it could propose standards for the scheduling of maturities and study the effect of these programs on local tax rates and tax burdens; it could set up reasonable priorities for various types of improvement as an aid to localities in planning their debt financing.

In the case of purchasing, the opportunity for establishing standard specifications, standard costs, standard quantities of materials for various kinds of undertaking, stated in terms of units, is too evident to require elaboration.

Guidance. The second phase of supervision is educational in nature. The state department should guide, instruct, and where necessary assist local officials in the performance of these essential financial functions.

In the case of budgeting, the educational activity and service would include preparation of budget forms, formulation of a technique for preparing budget estimates, instruction in the proper procedure of budget adoption and of budget execution, particularly the handling of allotments. It would include, further, compilation of an array of factual data relative to different local services, such as protection, education, health and the like, and computation of reasonable unit costs for these services as an aid to the several communities in measuring their own expenditures. Such information, assembled and classified by sections or regions, would permit useful comparisons among communities of similar general situation and size. The local officials should, when necessary, be given actual instruction or assistance in making up the budget.

The technique of accounting is so well established, and the checks on accounting accuracy that are provided by competent audit are so effective, that the state department's educational activity in this field would no doubt be confined largely to the preparation of forms and various formal instructions to all accounting officers and employees as to the proper handling of their records. The local accounting system could be developed so as to produce data for unit costs that would be extremely valuable for other aspects of the supervisory work. The contemporary audit, which is a function of the office of the controller, should be made locally, but the final or post-audit should be made or closely supervised by the state department.

With respect to local borrowing, a considerable amount of educational activity would ordinarily be required. Every community should be re-

quired to prepare a capital improvement program, covering the projects to be financed by borrowing. Every bond issue involves a long-term commitment to levy taxes and make periodic payments of interest and principal, and no borrowing should be done without careful advance consideration of needs and costs. The state department's services will be helpful here, in the accumulation of facts that bear on the community's need for the improvement, on its economic circumstances and prospects, on its ability to provide the revenue for the debt service to maturity, and on the relation of any particular loan project to the entire improvement and debt-creating program for that community. At this stage, the state department's influence would naturally be devoted to the concentration of attention upon these facts, and to the development of a program of such proportions and for such essential purposes as were in accord with the need and the local ability to pay.

The data compiled in the whole course of the supervisory activity would be useful in guiding local officials in their determination of reasonable costs for improvement projects. While such information might not be required in all cases, there are many instances in which local officials sorely need other information regarding building or construction costs than that obtained from interested architects and contractors.

The educational aspect of supervision over purchasing would include guidance and instructions relative to the preparation of specifications, the technique of inspection of materials supplied, the form of contracts, and such other matters as would be helpful in aiding local officials to get the utmost value possible for every dollar of the people's money that is spent. In small communities the overhead of a purchasing department would probably run to more than the savings of central purchasing, but in all cases the type of guidance suggested here would be helpful to all who must buy materials, supplies or equipment.

Inspection. The third stage of supervision involves examination of the results of local administration and the authority to insist upon certain standards of achievement. Curiously enough, the exercise of such powers in the case of local property assessments has long been recognized as essential, but in the case of the other aspects of local finance, hitherto unsupervised except in a superficial manner, there will be, inevitably, sharp opposition from local officials.

The essential purposes of supervision will be adequately achieved if the state department of local finance has unquestioned authority to require compliance with its general rules and principles. Thus, in the case of budgeting, it will be sufficient to make certain that the general requirements of sound budget procedure have been observed, that is, that every spending unit should prepare, adopt and execute a comprehensive budget in accordance with the form and procedure established, and that such unit shall operate within this budget. If emergency expenditures are

necessary, for purposes or in amounts not covered in the budget, the approval of the central authority should first be obtained. It would be unnecessary and unwise to permit a central authority to control the amounts budgeted for specific services, thus giving it a veto power over specific appropriation items. Further, it is unnecessary and unwise for the state to establish mandatory requirements for local salaries or the number of employees in any local service. On a very different footing is legislation requiring that local budgets carry adequate provision for sinking funds, interest and debt maturities.

The final supervisory control, in the case of accounting, should be sufficient to see that proper accounts are kept, and kept properly. If practices or conditions contrary to good financial policy are revealed by the final audit, the state department should have authority to compel the necessary changes or corrections.

The final purpose of local debt control is the prevention of unwise and unnecessary local borrowing, and the essential application of the third stage of supervision in this instance is, therefore, the prevention of such borrowing when there is an obvious case against it. Such a case may be clearly made, even if the community in question has not yet reached the maximum that would be permissible under a statutory debt limitation. The impossibility of covering a wide variety of cases under a single statutory formula indicates the need for some method of flexible control within this formula, and frequently upon a lower level than would be authorized by the formula. Had the states generally been exercising a proper sort of flexible local debt control during the twenty years prior to the depression of 1929, there would not have been the widespread municipal defaults and financial embarrassment due to burdensome taxes for debt service during the depression years.

Final supervision over purchasing should not extend to the point of requiring local purchasing agents to buy particular brands, types or quantities of materials or equipment. The supervising authority should, however, be permitted to ascertain the extent to which these agents lived up to their own specifications in accepting deliveries, and the degree to which genuine competition prevailed in the bidding on substantial orders. It should not attempt to determine the local standards of taste and beauty, except as this would be done indirectly by influencing the amount that could be borrowed for a local public building, or by requiring that the budget appropriations for supplies be not exceeded.

The diverse and incomplete development of central supervision over these aspects of local finance that has occurred hitherto is characterized by a mixture of severity and leniency that amounts to negligence. Some states audit local accounts rigorously, yet they are indifferent to local budget procedure; others watch keenly the local appropriations for debt service, yet they give little thought to the creation of new debt; others

have enacted debt limitation laws that are ostensibly strict, but in reality full of loopholes which are being constantly used to increase local debt. These conditions may be expected to continue until the entire scope of local finance is brought under a single, unified supervision.

Supervision of local finances in New Jersey. A series of laws enacted in 1938 provided the state of New Jersey with a system of fiscal control which combines the advantages of an effective safeguard of local finances with a large measure of local freedom in the operation of these finances. A full account of this legislation is impossible here, but a summary outline may serve to indicate the scope of the program.⁸

The Local Government Board. The keystone of the program is the Local Government Board, composed of three members appointed by the Governor for six-year, overlapping terms. To the board were transferred the functions of various commissions and boards that had been created earlier to deal with various aspects of local finance. It was also authorized to administer the other legislation relating to local finances that was enacted at the same time. This legislation embraced the following matters:

1. Local budgets. The Local Government Board was empowered to prescribe the form, itemization, and arrangement of local budgets. The act specified a sufficient detail with respect to the proposed expenditures for the several operating services to make certain that these would not be concealed in a short, general statement, as had frequently been the practice theretofore.

The new budget act also defined a cash basis of local operation and provided that all local units should so plan their affairs as to be on a cash basis not later than the year 1944. This goal was achieved, except by some half dozen small units.

The concept of a cash basis is sufficiently novel to be worth setting out in the terms of the law.⁹

A county or municipality shall be upon a full cash basis when all obligations and disbursements representing lawful expenditures under a budget for the current fiscal year, together with all current obligations and deficits remaining unpaid from all preceding fiscal years are paid or provided for in full from cash reserves and revenues actually collected during such current fiscal year.

The local budget act placed emergency appropriations under the control of the Local Government Board, thereby terminating a fruitful source of local mismanagement. In theory, an emergency may transcend the most careful budget planning, and the easy-going deflections of an emergency which once characterized both the local and the national

⁸ Cf. Princeton Local Government Survey, *Legislative Proposals*, Legislative Memorandum No. 1A, Princeton, 1938.

⁹ *New Jersey Statutes, Annotated*, Title 40, Chapter 2, Section 22.

practice were loose enough to permit large expenditures outside the authorized budget. The central control now provided limits spending of this sort to the bona fide emergency conditions.

Finally, the new budget act required the preparation of a capital budget before borrowed funds for capital purposes could be expended. The object here was to compel careful preliminary consideration of the need of the projected improvement, an advance demonstration of how it was to be financed, and its place in a general capital improvement program.

2. Fiscal administration. Another act in the series transferred to the Local Government Board the authority previously vested in various agencies over accounting, reporting, auditing, and sinking fund administration in local units. Control along these lines had already been developed in the state, but the new legislation clarified and extended state administrative authority over the routine mechanics of local fiscal administration, strengthened state inspection and laid the groundwork for modernized reporting practices.

3. Fiscal supervision. The purpose of this act was to impose special restraints upon municipalities which developed certain definite signs of unsound fiscal practices. By thus acting in time, financial conditions would be forestalled which would burden taxpayers and impair, if not destroy, the efficiency of local services. The act laid down the following tests or indications of unsound fiscal condition: ¹⁰

a. A default in the payment of principal or interest upon bonded obligations, or bond anticipation obligations, for which no funds or insufficient funds are on hand and available.

b. Payments due and owing the state, county, school district or special district, or any of them, are unpaid, for other than the year just closed and the year next preceding that year. (Municipalities are the tax collection districts in New Jersey and if collections decline the municipalities are likely not to settle in full with other units for their respective shares.)

c. An appropriation for "cash deficit of preceding year" in an amount in excess of five per cent (5%) of the total amount of taxes levied upon real and personal property for all purposes in such preceding year is required to be included in the next regular budget and was required to be included in the budget of the year just closed.

d. Less than fifty per cent (50%) of the total amount of taxes levied for all purposes upon real and personal property in the taxing district, in the year just closed and in the year next preceding that year, respectively, were collected during the year of levy. This provision shall apply only if more than twenty-five per cent (25%) of the amount of such taxes for such year next preceding remained unstanding at the end of the year just closed.

e. The appropriation required to be included in the next regular budget for the liquidation of floating debt exceeds twenty-five per cent (25%) of the local budget (except appropriations for schools and for floating debt) for the year just ended.

¹⁰ *New Jersey Statutes, Annotated*, Title 52, Chapter 27A, Sections 65-79.

If any of the above conditions be found to exist in any local unit at the close of a fiscal year, the restrictive provisions of the act become operative. These restrictions are:

a. No indebtedness, bonded or otherwise, shall be incurred by the local unit, except (1) tax anticipation obligations or other obligations of a strictly current character, (2) funding obligations authorized by other provisions of law, (3) obligations issued in compliance with the order of a state board or department, such as the Department of Health, etc.; (4) obligations issued with the approval of the Local Government Board to finance measures for the relief of unemployment.

b. The amount to be raised by taxes on real and personal property shall not be raised by more than five per cent (5%) in excess of the amount for the year next preceding the year in which the act takes effect.

If the condition relative to floating debt be the only one of the tests of unsound condition to exist, the Local Government Board may authorize special measures for its liquidation without imposing the restrictions just enumerated. The supervision of the Board shall continue, however, for the duration of the liquidation plan.

The excellent features of this system are fairly apparent. Similar general provisions with respect to budgets, accounting, and reporting are to be found in various states. The cash basis requirement is unique, and the New Jersey plan is distinctive in that, aside from the requirement that local officers shall comply with these general standards of good fiscal management, there is no state interference with the conduct of local affairs while these affairs are competently managed. Already it has been accepted as a reflection upon local administrative capacity to become subject to the special supervision of the Local Government Board because of unsound condition. A local régime that permits this to happen is very likely to be headed for trouble at the next election. There is thus created a strong motivation to manage local affairs in such wise as to avoid, not only the stigma but the very realistic penalty of the loss of public office that may be involved.

CHAPTER IX

The Effects of Public Expenditure

THE DISCUSSION of public expenditure to this point has been directed mainly toward certain formal and material aspects of the subject, such as a proper scheme of classification, the increase of expenditures in recent times and the best means of controlling this tendency. The present chapter deals with the effects of public expenditure. Before proceeding with this subject, various technical terms which have become part of the vocabulary of public finance should be explained and distinguished.

THE TERMINOLOGY OF PUBLIC EXPENDITURE

Real versus nominal expenditure. The first distinction is that between the real or actual cost of government and those payments which are not part of this cost, although they appear in the treasury record of disbursements.¹ Illustrations of the latter are transfers between departments, and the funds collected by one unit of government and disbursed for or on behalf of other units. The real cost of government is sometimes characterized as onerous expenditure, while the transfer and agency payments are evidently burdensome expenditure so far as concerns the agency unit.

Whether all of the actual cost of government is onerous or not will depend on the viewpoint adopted in measuring burdens. Expenditure from the income of trust funds is part of the actual cost of government, but if the fund has been given by a private donor for public use, such expenditure is not burdensome to those who must support the government. Expenditure from the receipts of a publicly-owned commercial enterprise, for the operation of this undertaking and the maintenance of its capital equipment, is not a burden on taxpayers, although a government monopoly may be charging rates higher than would be charged under competition, and thus, relatively to the competitive price scale, there may be an element of burden in such rates. Without doubt, the deficit from a commercial enterprise which is borne in the general budget is burdensome. Expenditures made for the development of future revenue-producing resources are onerous, but the temporary burden may

¹ A. C. Pigou, *A Study in Public Finance* (1927), Ch. III uses the terms *exhaustive* and *transfer* expenditure.

be counterbalanced after the production stage arrives. The original provision of a revolving fund is a burden on the taxpayers, but once this fund is set up, successive projects may be developed thereafter without further burden, insofar as the investment is returned from each project for use in the next.

Ordinary and extraordinary expenditure. A second distinction is that suggested by the terms *ordinary* and *extraordinary* expenditure. These expressions are widely used, especially in budget terminology, but their meaning can be as variable in finance as in conversations about the weather. Nitti defines ordinary expenditure as that made to meet continuous needs; extraordinary expenditure as that made in response to accidental or variable needs.² The former occur in each fiscal period, the latter are fortuitous. Bastable presents a similar view of the ordinary expenditure, but he defines extraordinary expenditures as those for "unanticipated extra demands arising in most cases from fresh calls upon the state."³

Perhaps the most definite sense in which the terms *ordinary* and *extraordinary* can be used is that proposed by Nitti, which implies a relationship between the expenditure and the source of the funds. Ordinary expenditures should be met from ordinary, current receipts. Extraordinary expenditure may likewise be met from current revenue, but the term implies that it may be met otherwise, which would naturally be by borrowing. The distinction is not parallel to that between current and capital expenditures, however, for there may be circumstances in which certain types of capital outlay should be met from current revenue. For example, the construction of a new school building or the paving of the principal street in a small town could properly be classed as extraordinary expenditure and financed by borrowing; since it would occur only at very infrequent intervals. In a large city, where one or more school buildings and several miles of street paving are required annually, such expenditures are really part of the ordinary recurring cost of the schools or the streets, respectively, and it would be proper to meet them from current receipts, although they are for capital improvements.

In these illustrations the time element in the period of recurrence is important, as is also the volume of the particular expenditure in relation to the total annual flow of current receipts. The point at which a given outlay passes from one category to another is not easily fixed, and its establishment in particular cases requires the application of common sense and judgment. At one extreme, however, borrowing would be justifiable, while at the other the case for the use of public credit is dubious, at least.

Many persons will regard this as a debatable issue, and it is easy to anticipate the arguments that would be urged on either side. Since it

² F. S. Nitti, *Principes de science des finances*, p. 133.

³ C. F. Bastable, *Public Finance*, p. 130.

involves the principles underlying the use of public credit, further discussion is deferred to the chapters dealing with that subject.⁴

It should be noted, as both Cohn and Bastable point out, that in a sufficiently long view the extraordinary expenditure tends to become ordinary, in the sense that even casual or fortuitous events may recur, though the period may be irregular. Wars, economic depressions, earthquakes, floods and other happenings do recur. At the first impact of any emergency, the new level of expenditure required to deal with it is distinctly extraordinary, in contrast with the scale of government effort previously required. But if the effect of such an event is prolonged, the expenditure required quickly loses its emergency character. In a surprisingly short time the budget and the popular psychology are adjusted to the new level of expenditure, which is thereafter viewed as normal or ordinary, as in fact it is, from the new viewpoint. For this reason, possibly, nations encounter difficulty in contracting their administrative organization and reducing the volume of expenditures at the close of a war or of some emergency that has brought about great expansion. The extraordinary has become the ordinary, and it is not easy to view the administrative structure in a sufficiently detached way to appreciate the necessity for contraction and retrenchment in its scope and expense. Strangely enough, taxpayers are often apathetic, although they should be alert.

In other words, the idea of an indefinitely prolonged emergency is not a consistent concept, although governments sometimes manage their finances as if it were. While the federal government did not attempt to meet its entire costs during either of the World Wars from taxation, the federal tax system was broadly expanded as the wars went on, and no attempt was made to segregate ordinary and extraordinary expenditures. In dealing with the depression of the 1930's, however, this distinction was invoked, with the result that the tax system was expected to supply only the ordinary expenditures.⁵ The classification, as set up in the federal budget, was necessarily arbitrary, and took no account of the fact that a considerable portion of the so-called "emergency" expenditures were in fact ordinary, since they had been made in earlier years and were quite likely to be made in future. It permitted the statement to be made that the general or ordinary budget had been balanced, but it could not obscure the fact that the federal tax system had not been broadened sufficiently to prevent the continuance of heavy borrowing.

⁴ Cf. below, Chapter XXXI. The New York Joint Committee on Retrenchment and Economy recommended the "pay-as-you-go" policy for all non-revenue-producing improvements in larger cities. The committee is emphatic in saying that the city which is spending from \$10,000 to \$25,000 annually for street paving should not plan to remain in debt continually for the cost of such improvements. *Report of the New York Joint Committee on Retrenchment and Economy*, 1920, p. 83.

⁵ The terms *general* and *emergency* were used in the budget for 1936, but this shift in terminology meant no change in policy, and it was dropped in the budget for 1937.

Productive and unproductive expenditure. The terms *productive* and *unproductive* refer to an elementary but basic economic distinction in the character and results of human effort. This effort or activity is productive if it results in something that will satisfy wants, or as the economist puts it, in the creation of utilities. Otherwise it is unproductive. Effort for purposes that would normally be productive, but which involves costs greater than the utility or want-satisfying power of the result, is unproductive. The disutility of the cost exceeds the utility of the product, and everyone would have been better off if this particular activity had not been undertaken.

With proper allowance for a certain difference in emphasis these concepts may be applied to the operations of the state as to those of the individual. The difference is required by the fact that the return to productive effort may be either reproductive or non-reproductive. The former means a direct material return, the latter an indirect, intangible, immaterial gain. Individuals are chiefly concerned with reproductive activities, that is, they must receive at least enough to cover the cost in order to stay in business at all, and they are not likely to do so for very long unless there is some prospect of a profit. On the other hand, much of the state's activity is non-reproductive, and the pecuniary profit motive is not the controlling test of advantage. The expenditures for properly managed public commercial enterprises are reproductive, for they bring a return to the treasury. Those for schools, roads, sanitation and other public services are non-reproductive. Their justification is in the resulting general social advantage rather than in any direct financial return for the money spent. In fact, the bulk of all public expenditure is of the non-reproductive sort, since the purposes of the state are largely intangible and immaterial.

The inevitable vagueness of the purposes of state activity makes it extremely difficult to determine whether any given amount or object of state expenditure is productive or unproductive. It is clearly possible that some public expenditure may be unproductive, and the indefiniteness of the results renders careful planning and sound judgment the more necessary. The desirability of avoiding wasteful public expenditure for any purpose is here assumed. This means repudiation of the doctrine that lavish expenditure, per se, is a good policy. Scarcity is the controlling fact in the economic world, and the struggle against scarcity is the dominant motive in all economic activity. Waste is therefore the most serious offense against economic law. It is necessary to be continually alert with respect to the public expenditure, for waste may occur, even in the performance of the government's most appropriate and desirable functions. For example, roads are essential, but it is easily possible to build more highways than are needed, or to locate them disadvantageously, or to provide a type of construction not warranted by the traffic situation.

Likewise, education is an important public service, but it is possible to spend wastefully for education. There is no public service in the discharge of which waste is impossible.

If this position be correct, the question of tests or guides to aid in arriving at a judgment regarding the economic character of public expenditure becomes very important. It is extremely difficult to devise or apply adequate tests, and the tentative nature and limited scope of the following suggestions are fully recognized.

Tests of the productivity of public expenditure. The first guide or test that might be used is that provided by standards of service. The analytical breakdown of a government service that would be made in stating its quantity and quality in terms of appropriate standards might not, in all cases, reveal the degree to which it should be regarded as unproductive, but it would permit closer approximation than is possible otherwise.

The use of standards in the case of highways would involve careful traffic surveys to determine, first, where roads should be built and second, the kind of road required by the volume and character of the traffic that will use it. It would involve also the setting of standard specifications for each type of road. A light volume of purely local traffic might justify simply a gravel road, with proper grading and drainage. The heaviest traffic might require a six or eight lane highway of heavy concrete construction. It requires but little familiarity with the highway network that has been produced by the feverish activity and the unstandardized methods of the past forty years to reveal the amount of unproductive highway expenditure that has occurred, judged by any sort of traffic test.

The best test for the discovery of unproductive expenditure is the pragmatic one—what is the effect or result of the expenditure? This is, unfortunately, a belated test, but it is possible to provide a continuous correction of the governmental method, through consideration of the results of past operations. This test may reveal errors in the method of providing public services as well as in the amount or in the purpose, for it is evident that the unproductivity of certain expenditures may result quite as much from a wrong method of providing the service as from the purpose itself. Some illustrations may make the point clearer.

In the case of the armament expenditure, the proper purpose is, or should be, national security and international peace. Insofar as expenditure on armament promotes these essential and highly desirable purposes, it is productive. But if large expenditure for armament promotes war, the expenditure is wasteful. The world is now able to apply this test thoroughly and convincingly. For the taxpayers in all countries the answer is conclusive—large armament leads inevitably to war, and the preparedness expenditure is only a small part of the total waste caused by war. Unfortunately, the interests of taxpayers are as little considered as

are the interests of civilization itself, by those who are most influential in determining this aspect of national policy.

The test of the productivity of expenditure for public education would be the success of the educational effort in developing intelligent citizens, capable of self-government under a democracy. Education may have other objectives, but they are all subordinate to this primary purpose. If the chief result of education is the development of a sheep-like attitude, a herd-mindedness, easily influenced and led by any blatant demagogue, prancing buffoon, or sensational newspaper, it would certainly indicate that the educational method was wrong and that the educational expenditure had been largely wasted, for such results could have been achieved without spending the vast sums that have been devoted to education.

Again, if relief expenditure prevents distress without destroying self-respect and the instinct of self-support, it is productive. If it breaks the morale of those relieved and promotes shiftlessness, the evidence should be clear that the method of relief was wrong and that the expenditure had been, in consequence, largely unproductive.

It should be noted that the ready availability of large sums for expenditure naturally promotes disregard of the effects. It is not only more difficult, as a matter of administration, to spend a large sum wisely; the fact that an immense amount is easily available diminishes the need of seeking the best results. Lavish expenditure for any public purpose is therefore likely to involve a relatively great degree of unproductive expenditure.

A final test to be suggested is the relation of the expenditure to the taxable resources of the community. This test is applicable in the case of all public expenditure, whether productive or not. The patrimony of the state must be preserved, as Adams put it, and an expenditure program that would impair, or even threaten the solvency of the nation or the capacity of the people to carry the tax load involved, would for the long run be indefensible. A range of governmental services so extensive and so expensive as to have such effects would cease to be productive, however strong the case might be for each service in itself.

No definite limits or ratios of expenditure to national income can be set. Such ratios are elastic. The people can and will endure, for a short period, far heavier taxation than could or would be borne for a long period. Within limits, too, capacity involves the popular will and desire. Heavy taxation for any cause that is enthusiastically supported can be borne for a time by making personal sacrifices, reducing living standards, diminishing the flow of funds for capital purposes, and so on. This kind of fervor is likely to be short-lived, unless it is skillfully whipped up by strong appeal to some deep-seated national or racial prejudice. Fundamental economic impairment must come eventually, however, no matter

how keen and sustained may be the popular feeling, if the government's expenditures take a proportion of the national income that prevents the maintenance of wholesome living standards and the preservation and growth of the nation's capital.

THE ECONOMIC EFFECTS OF PUBLIC EXPENDITURE

The distinction between productive and unproductive expenditure provides an approximation to the question of the economic effects of such expenditure, but the subject must now be approached from another angle. In the following discussion the emphasis is shifted from the basis of the benefits or disadvantages of public expenditure for the community in general, to that of its effects on particular groups. That is, the individuals who compose the community are at once producers and consumers of wealth. State policy, expressed through the volume and the purposes of public expenditure, affects both the production and the distribution of wealth. It is necessary also to consider the various ways in which the funds are obtained.

The effect on the production of wealth. From the nature of the state and the character of its services, it would be reasonable to expect that state activity would promote the effectiveness of the productive processes. Much of this influence is exerted indirectly. Illustrations of these beneficial services are the maintenance of internal order and external security, the provision of means of communication and transportation such as the postal service and the highway system, and the promotion of various lines of scientific research, whereby new processes are discovered, plant, animal, and human diseases and pests are controlled or eradicated, and improved varieties and strains of useful plants and animals are developed. It is in this sense the governmental activity, and therefore governmental expenditure, is productive. In large degree such expenditure does not directly increase the aggregate of wealth produced, but it does so indirectly through the creation and maintenance of the conditions under which private activity is rendered more productive. In like manner, the suspension or collapse of the ordinary governmental services diminishes private productivity. If the police service were suspended, for example, business operations would be paralyzed. Robbery, inextricable traffic confusion, and the spread of crime would force most places of business to close. If all health and sanitary efforts were discontinued, the spread of disease would soon incapacitate large numbers of workers. If education were abandoned, the nation would speedily become so illiterate as to lose much of the benefits of scientific achievement and cultural progress.

The advantage of state activity, from the standpoint of wealth production, is so obvious that it needs no further elaboration. Nor is it necessary

to emphasize that all groups, whether of laborers or capitalists, are benefited thereby. It is important to realize, however, that state activity is subject to the principle of diminishing return. That is, a certain amount of state service may greatly promote private economic productivity, but beyond some limit of expenditure, the additional installments of state service may add little or nothing to the wealth produced or the social benefits derived therefrom. Just where this limit lies cannot be definitely stated, hence the emphasis in preceding pages on the need of tests for discovering when public expenditure, even for the most worthy purposes, becomes unproductive. Disregard of this caution has led over-zealous exponents of large public expenditure to take the position that all expenditure is productive, regardless of amount or purpose. Such an uncritical attitude has underlain the endorsement of enormous armies, elaborate municipal improvements, and numerous other instances of inordinate expenditure that later experience revealed to be unproductive.

In some degree public expenditure may add directly to the aggregate of wealth produced. Well-run government commercial enterprises, reforestation and reclamation projects, and other forms of state business are the most obvious illustrations. Even the expenditure on ordinary services may result in the accumulation of certain assets, such as public buildings, which are a useful addition to the aggregate community wealth, provided they are not created, through spending for its own sake, in an amount beyond the capacity of the community to pay for or use advantageously. In properly managed prisons employment has replaced idleness, and many things are produced therein for use in other state institutions.

The danger of direct state production coming into competition with private production is always present, however, and if this happens it may lessen the net value of the public efforts to add directly to the stock of wealth. If government operation, after complying with the conditions and conforming to the standards that private business must meet, can supply goods or services at the same or lower prices than the private concerns, there can be no question of the economic productivity of the public expenditure on behalf of such undertakings. If large deficits are regularly incurred, the propriety of the public enterprise must be defended on other grounds than that of its productivity.

The effect on the distribution of wealth. Turning from the production to the distribution of wealth, it is apparent that both the amount and the purposes of public expenditure may influence this distribution. The extent of such influence will depend on the character of the revenue system or of the other sources of public funds. The provision of beneficial governmental services constitutes an addition to the real income of everyone. Peace, order and security cannot be bought by individuals. Health, the cultural benefits of education, the comforts of modern

sanitation, the allure of cheap travel over fine highways—these are definite and positive additions to the real income of all.

Furthermore, various types of expenditure constitute an addition to money incomes in some cases or a net money saving in others. Pensions, annuities and other payments to veterans and the aged, and the profits made by the concerns which do construction or other contract work for the government illustrate the gains to cash income, while the provision of free school books, free dispensaries and clinics, illustrate cash savings for the beneficiaries.

In general, the effect of public expenditures, as revealed by the recent trends, has been toward the equalization of incomes. The spread of progressive taxation on incomes and inheritances and the increasing weight of property taxes have led to heavy levies on income and wealth, while the growth of expenditures for social welfare purposes has resulted in large governmental benefits for those of small incomes. Sales and commodity taxes have counteracted the progressive character of modern taxation to some extent, but the welfare element so predominant in modern public services has continued. Some advocates of the further extension of state services hold that there is no necessary limit to this tendency short of a fairly complete equalization of incomes.

Such a goal may be possible, but it seems quite undesirable, of realization. It would inevitably commit the government to a huge amount of unproductive expenditure, through the attempt to increase certain incomes without regard to the equivalent productive service rendered, and also through the launching of vast employment projects for which neither economic nor social justification existed. The crippling effects of such a policy on the aggregate capital accumulation and current wealth production cannot be definitely measured, but the possibility exists that all wants would be less adequately supplied after such a leveling process than at present.

It is sometimes contended that changing social conditions warrant an indefinite expansion of government activities and expenditures because of their alleged contribution to the enlargement of real income, particularly at the lower income levels. Were this to be permitted, the satisfaction of wants would be shifted from the individual plane to the communal plane. In this view the citizen is evidently regarded as a moronic being who would be entirely satisfied with an ever diminishing carry-home cash return for his economic effort, provided that a beneficent government supplied him with an ever greater flow of utilities on a communal basis.

This raises the important question of economic motivations in relation to productive effort. In order to execute a program of supplying a larger flow of satisfactions, government would need to increase taxes, thus diverting a larger share of private income to public use, or to cover the

cost of the benefits by inflating credit and currency, thus reducing the buying power of a given amount of private income. Under either method of financing, the process of supplying wants on a communal basis would be a substitution of a public judgment regarding the things to be bought, for the private judgments of the individuals who worked, or planned, or saved, to get the income.

For example, suppose that every one worked eight hours a day and five days a week, or forty hours a week. If the federal income tax were to take 20 per cent of each income, it would mean that for one day out of each week the workers were working to support such things as some federal agency had decided the income should be spent to support. If the tax were to take 40 per cent of each income, two days of each week would be devoted to working for these public purposes. How much of the week can an individual be required to devote to working merely for the purpose of allowing someone else to spend his income, without impairing the incentives to work or to save with a view to gaining income through investment? It is not enough to say that the workers are receiving a share of the benefits that are provided by the public spending. That argument may hold to a certain point, but if pushed too far it approaches the conclusion that individuals would be ready to work as hard if their entire income were taken for public purposes as they would if only a moderate proportion were so taken.

THE SOURCES OF THE FUNDS

There are two principal methods by which government may obtain the funds to finance its expenditure program. One of these is by an actual diversion of purchasing power from private to public possession, either through taxation or the sale of bonds that are fully paid for at once out of income by the private purchasers. The other is by creating purchasing power *de novo*. Illustrative of this method is the delivery of bonds to banks in exchange for deposit credits, the issue of an inconvertible currency, or the devaluation of the monetary unit. While the two methods of providing funds may be used in combination, as occurs when tax revenues are supplemented by inflationary bond sales or by use of paper money, the former is that used under normal conditions by governments which are seeking to operate on a sound fiscal basis. Resort to the latter method is always an indication of financial weakness or difficulty.

Funds derived from the people. If the public funds are obtained through taxation or by the bona fide sale of bonds outright for cash, the purchasing power thus gained by government equals that surrendered by the people. The aggregate volume of purchasing power is unaffected. Some differences in emphasis may naturally be expected, although these

differences may not be serious in final analysis. If taxes are less heavy, individuals may save more, and thus the nation's capital is increased. But government may use the funds to finance a publicly owned commercial enterprise, although it may not observe the same standards of profitable operation as those to which private business must adhere. Individuals may have used the money otherwise paid in taxes or bond subscriptions to build houses, whereas the government may construct a road or a public building. In such case the direction of the demand for labor and material will not be greatly different. Individuals may have traveled more, or spent more abundantly for consumption goods. On the other hand, the government may increase its staff of employees, for some of whom travel expense is provided, and the increased expenditure for salaries will lead eventually to demand for various kinds of consumption goods. Or, to take a final illustration, if taxes had been lighter, individuals might have wasted part of their incomes in fraudulent enterprises. Government is also capable of wasting the funds provided through taxation.

In general, it may be said that the aggregate volume of available purchasing power is unchanged, when public funds are secured by transfer from private to public possession; and, while some differences in the emphasis of public and private demand exist, these ordinarily lead only to changes in particular prices. Government demand replaces private demand, and government requirements for labor and material by and large are sufficiently similar to private requirements to cause no serious price dislocation. The general price level should not be affected by such replacement.

It is understood in this discussion that government will observe the ordinary conditions of the market for materials and labor. That is, it will pay fair market prices, without commandeering either labor or material, and its employees will give a fair return for their compensation. Failure to observe these conditions may distort prices or wage scales and thus produce effects not to be found in the expenditure made by individuals.

Nothing can be said at this point of the varying effects of different forms of taxation in providing public funds, although it is clear that these effects must be considered, particularly with respect to different groups and classes in the community. This phase of the subject must be deferred until the subject of taxation has been discussed.⁶

Funds created *de novo*. If the government provides a substantial part of its own purchasing power in ways that do not involve a diminution of private purchasing power, quite different effects from those noted above may ensue. The creation of purchasing power *de novo*, in whatever way accomplished, means inflation of monetary or deposit currency. The aggregate volume of private purchasing power is not diminished, and

⁶ Chapter XXIX.

the government demand for labor and materials is added to the private demand.

The character of the results will depend on the popular reaction to the government's policy. If not carried too far, it may inspire confidence. On the other hand, the effort to establish or preserve confidence while creating additional purchasing power on a large scale may be neutralized by the popular fear that the inflation may get out of control and so lead to disaster.

The initial effects of inflation. Assuming that public confidence in the stability of the government is not impaired by the inflation policy, and such may be the case in the early, mild stages, the additional government demand for labor and materials should stimulate price and wage increases. As this occurs, the effects are those familiar to any period of rising prices. Fixed income groups lose, while variable income groups gain. Whether this is a correction of a former unbalance in which the fixed income groups had too great advantage by reason of low prices, or is a definite further shift of advantage to the variable income groups, will depend upon the recent course of general prices.

Public confidence is not likely to remain unimpaired indefinitely, under the impact of substantial inflationary government spending. The immediate or temporary effect of diminished public confidence may differ from the ultimate effect.

In the first stage of a collapse of confidence, private investment spending declines. Uncertainty over the future discourages long-term commitments. The heavy or capital goods industries are likely to be most seriously affected, from the investment standpoint, by the gloomy long-range outlook, since investment in this field is not revocable and the full return is received only after a lapse of time. The uncertainty creates a preference for cash liquidity over goods and equities. Hoarding increases, either as cash or as idle bank deposits. Liquid capital funds are transferred abroad, unless blocked by the government, although such a step would accomplish nothing toward the restoration of confidence. The rate of monetary turnover subsides. The immediate effect of inflationary government spending on the price level may therefore be largely negated by private inaction.⁷

The ultimate effects of inflation. The second stage in the collapse of public confidence arrives when monetary or credit inflation, or both, have reached a point that indicates the inability of the government to change its course, or that gives rise to general fear as to the impossibility of such a change. It makes little difference in the final outcome whether the public spending is for relief and other socially approved purposes, or is for some object arbitrarily planned and executed by a dominant faction for partisan or personal aggrandizement.

⁷ Cf. E. W. Kemmerer, *Money* (1935), pp. 113 ff.

As this stage develops, the tempo of both private and public spending accelerates. The community develops a preference for goods and equities as against cash and bank deposits, a preference inspired by the belief that the purchasing power of money is destined to decline in future. The general disposition to exchange money for goods sends prices upward, and the result is a state of panic quite similar in its psychology to the depression panic, except that everyone is seeking to buy, instead of to sell, goods and equities. The more prices rise, the more frantically buying proceeds. The progress of this vicious circle affects the government, which cannot obtain enough revenue for its needs by ordinary taxation, in view of the lag of tax receipts behind rising costs, and it is therefore obliged to create more purchasing power in the effort to keep pace with rising prices, but this action merely stimulates further the price advance.

The final effect of such a price revolution is, of course, disastrous, for it is not likely to halt short of complete worthlessness of the existing currency. As the value of the monetary unit approaches zero, debtors benefit enormously, since a debt obligation that formerly represented a substantial value in purchasing power can be wiped out with a ridiculously small proportion of its earlier value. During the inflation of the Continental currency in the later years of the American Revolution, John Witherspoon, president of Princeton University, wrote: ⁸

For two or three years we constantly saw and were informed of creditors running away from their debtors, and the debtors pursuing them in triumph, and paying them without mercy.

Inflation, it should be noted, is a kind of taxation. When government buying power that is created by monetary or credit inflation competes against private buying power, the people can buy less because of the rise in prices. This is the effect produced by taxation, for the taxpayers can buy less after having paid their taxes. The peculiar effects of inflation in this direction are discussed somewhat more fully in the chapter on the effects of taxation.⁹

⁸ J. Witherspoon, *Works* (1802), Vol. IV, p. 223.

⁹ Cf. Chapter XXIX.

PART II

Public Revenues: Commercial and Administrative Revenues

CHAPTER X

The Forms of Revenue

PUBLIC REVENUES are the necessary counterpart of public expenditures. The field of public expenditure has been surveyed, and it is now in order to examine the sources of public revenues. This study of public revenues will embrace first of all consideration of the various forms of revenue, or sources of revenue; secondly, the principles that should be observed in the distribution of this burden among the citizens; and finally, some administrative questions which arise in connection with any revenue system. The present part of the book is devoted to those sources of public revenue other than taxation, such as the public domain, public industries and the administrative revenues. Part III deals with taxation, which is now the most important, by far, of the several sources of revenue.

Historically considered, there was not always the clear distinction between expenditures and revenues that is now so generally made. Public income and public expenditure were often connected in the same act. Thus, the medieval retainer went to war at the call of his overlord, and he furnished his own arms, often his own subsistence. He was at the same time contributing to the support of the state and spending this contribution under the state's direction. The separation of revenues and expenditures began under the feudal dues and services, and it was completed with the general use of the money economy. The employment of hired soldiers, the rise of the central governments and the other advances which came with the money economy led to an increasing emphasis upon money receipts and expenditures. Today the use of money is universal.¹

¹ A curious reversion to payments in kind was authorized in the Oil and Gas Leasing Act of 1920 (*United States Statutes at Large*, 1920, Ch. 85) according to which the Secretary of the Interior was empowered to take the royalty payable under oil or gas leases in cash or in kind. The leases of naval reserve oil lands subsequently made provided for payment of the royalty in kind, by the delivery of crude oil certificates. These certificates were redeemable by the lessee in fuel oil, to be delivered at points designated by the Secretary of the Navy, or in cash, at the government's option. Steel storage tanks were to be provided by the lessee, but were to be paid for by the government, and the royalty oil certificates were made acceptable for this purpose.

The intention of this legislation may have been to assure the navy of its supply of fuel oil. Its effect was to provide a form of public revenue and expenditure which was not subject to the control of Congress, since the royalty oil certificates

THE CLASSIFICATION OF PUBLIC REVENUES

There has been a considerable discussion of the problem of a proper classification of public revenues. The importance of a proper classification of expenditures was discussed in Chapter III. For somewhat similar reasons the subject of revenue classification is also important. It is true, as Seligman points out, that the proper classification of the material in any field requires logical criticism and rigorous analysis, "it conduces to accurate definition and prevents looseness of expression, and it may have important practical results in deciding questions of fact." Bastable, on the other hand, is inclined to discount the importance of classification. He shows that historical peculiarities have given rise to differences in public organization, so that no one classification can be applied, and that sharp, clear-cut distinctions cannot be made between the various branches of public expenditure. In his view, content is more significant than form, and he insists that the supreme essentials of the material can be studied even with a faulty classification. It certainly is not worth while to magnify beyond reason the importance of classification, but there is no object to be attained from the study of either revenues or expenditures that is not furthered by organizing this study according to a reasonable classification. It is not necessary that the scheme used should be one that would be good for all time, or for all countries. The principles to be observed in formulating any such scheme are, first, that it be in reasonable accord with the natural arrangement of the material, and second, that it be such as will set in proper relief the principal sources of the public revenue.

The classification of revenues has received some attention from the writers on public finance since the Middle Ages. A brief reference to the earlier development of the subject will be instructive in illustrating the shifting emphasis upon different revenue sources at different periods.²

Revenue sources under cameralism. The cameralists reduced public revenues to three main groups: (1) the public domain, (2) regalian rights and (3) taxes. The first of these groups was of greatest importance in the period when the sovereign held his position in part, at least, by virtue of the fact that he had large estates of land which would yield him an income sufficient to meet the expenses of the royal household, and also because he had the nominal title to still other tracts of land which had been apportioned to the hierarchy of officials and followers, who in turn could rally men and means to the banner of the king. As the concept evolved of a state that was separate and independent of the estate of the

were not money which was turned into the Treasury, to be expended in accordance with appropriation acts.

² Cf. the list of revenues given by the French mercantilist, Jean Bodin, in 1576. Quoted by C. J. Bullock, *Selected Readings in Public Finance*, 2nd ed., p. 76.

sovereign, the domain became in time the *public* domain, that is, the property of the state and its sale or hypothecation, which usually led to alienation, was regarded until recent times as a suitable source of public revenue.

The second group, the regalian rights, were those rights and privileges that belonged to the king by virtue of his being the king. They were the attributes or prerogatives of sovereignty. The Roman Law had vested certain functions or privileges in the crown. These attributes had developed in the Middle Ages into a distinct body of economic rights, the revenues from which accrued to the sovereign.

Adam Smith's classification of revenue sources. The cameralists, in common with the earlier mercantilist writers, regarded taxation as the last and least of the sources of public revenue. Taxation cannot become an important source of revenue until there has developed in the state a body of wealth that can bear taxes. It remained for Adam Smith to point out this fact and to emphasize it clearly. The underlying thesis of his great book was the relation of the growth of wealth to the freedom of individual initiative. The wealth of the nation depends upon the wealth of its citizens. It was far better, he held, for the state to confine itself to strictly governmental functions, narrowly construed, and to derive its support from the taxation of the wealth which its citizens would amass when freed from governmental restrictions, than to undertake the development of peculiarly public or state sources of revenue.

According to Smith's arrangement there are two principal sources of public revenue. The first is some fund belonging primarily to the sovereign or to the state. The second is the revenue of the people. The sovereign's possessions may consist either of capital or land. Smith was skeptical of the steadiness or the volume of the revenue that might be obtained from these forms of publicly owned wealth. He concluded that the income from such sources would be insufficient and that the greater part of the state's expenses must be borne by taxation.

Revenue classification by modern writers. Modern writers have discussed the proper classification of the public revenues. Each suggests different categories, but there is fairly general agreement regarding the fundamental features. Professor Seligman, for example, divided public revenues into three classes: (1) gratuitous, (2) contractual and (3) compulsory.³ The first class comprises the free gifts to the state, the second the commercial revenues that arise as the result of contractual relations between the government and the citizen, and the third embraces the receipts that are obtained through the exercise of sovereignty in such ways as eminent domain, the penal power, the taxing power or the police power.

This arrangement is in one sense logically complete, but the author's

³ E. R. A. Seligman, *Essays in Taxation* (1921), Ch. XIV, p. 430.

discussion of its application is too restricted. Gifts from individuals are admitted to be insignificant, but for all governmental units except the federal government another type of gift has recently acquired significance. This is the subsidy or grant, usually from a superior to an inferior jurisdiction. No specific recognition is given, either, to public loans as a source of revenue. It would be possible, although rather confusing in outcome, to class these either as contractual or compulsory, according as the government sold its obligations to the people on a fair investment basis, or forced them into central banks under its control at interest rates dictated by it. Compulsion would also be used in circulating legal tender paper currency.

Professor Adams suggests the grouping of all public revenues as (1) direct, (2) derivative, or (3) anticipatory.⁴ Under the first head he would class all revenue that accrues to the state from public ownership in productive property, or public management of productive industry, or that falls to it by virtue of its sovereign character or corporate personality. Derivative revenue is that which is taken from the citizens under some revenue law, and the third class, anticipatory revenue, is that which is obtained through the use of public credit. The first group is too broad, since it combines the commercial revenues with those that are received in the exercise of strictly governmental or administrative functions. It is more logical to establish a distinct category for the latter class of receipts, and thus separate them from the strictly commercial operations of the state. Neither Seligman nor Adams recognize the bookkeeping transactions of which account must be taken in the complicated relations that often prevail among departments, and between the state and the local finances.

Bastable's suggested arrangement is reminiscent of Adam Smith.⁵ He proposes two main classes of public revenues: (1) revenues obtained by the state as a juristic person; and (2) revenues taken by the power of the sovereign. The first would include the economic revenues, rents, interest, the earnings of commercial enterprises, escheats and fees. The second would include all taxes, general and special, and all extra returns to state industrial agencies through privileges granted them. Bastable holds that the regalian rights were, in most instances, special property rights, and he would accordingly class them with the economic revenues. If there were an element of monopoly in the right, and if this resulted in any additional receipts, the surplus would be a tax. Fees are regarded as the economic receipts of the state agency to which they are paid. If they do not afford sufficient to cover the cost of this agency, the deficit is paid from taxation; if they just cover the cost, this state industry is just paying its way; and if there is a surplus, the state is obtaining a net revenue.

⁴ H. C. Adams, *Finance*, pp. 219 ff.

⁵ C. F. Bastable, *Public Finance*, Book II, Ch. I.

A PROPOSED CLASSIFICATION OF PUBLIC REVENUES

The following arrangement of public revenues is submitted as being more nearly in accord than any of the foregoing with the true character of the state's receipts from different sources.

1. Commercial revenues
2. Administrative and miscellaneous revenues
3. Taxation
4. Public loans
5. Subventions and grants
6. Bookkeeping revenues, or transfers

The commercial revenues are the parallel of the commercial expenditures in the scheme of classification offered in Chapter III. This arrangement permits the complete segregation of the economic activities of the state from the operations which it conducts as strictly governmental functions, and if followed in practice, it would permit an estimate of the degree to which these enterprises are self-sustaining. Both Adams and Bastable introduce an element of confusion by combining with the purely commercial transactions of the state such receipts as fees, escheats, gratuities and other incidental or purely administrative revenues.

The second group, the administrative and miscellaneous revenues, comprises the receipts which the state obtains in the exercise of its strictly governmental functions. This is a widely diversified group, including such forms as fees, fines, escheats, profits on the coinage and special assessments. For convenience in exposition, the receipts from miscellaneous sources are added here since they are largely a by-product of some administrative activity.

The administrative revenues are intermediate between the purely commercial revenues on the one hand and the receipts from the exercise of the taxing power on the other. At certain points they appear to partake of the characteristics of the first group, and at other points they seem more akin to the third group. Thus, the administrative charges or fees that are made by many governmental offices for special services rendered are, like the commercial revenues, payments for service to the individual. Bastable suggests that these public offices are like public industries, and that fees may therefore be likened to the commercial receipts. This comparison is misleading, and ignores the fundamental distinction between a charge that may be made in the exercise of a necessary governmental function such as the probating of wills, or keeping the record of real property titles, and the charges that are made by a publicly owned industry, such as a waterworks. The latter may be socially useful, but the business of operating a waterworks is hardly to be regarded as one of the essential functions of government.

On the other hand, the special assessment is also primarily an adminis-

trative charge, as will be shown later, but it partakes more nearly of the character of a tax, since it may become a compulsory charge upon the property holder in an improvement district. The fee system may also approach this end of the scale, since it is possible to establish a schedule of fees that affords a net revenue over and above the cost of the offices which render the services.⁶ Fines belong here also since they are revenues that are incidental to the governmental function of preserving order and internal security. If there are no offenders, there are no fines. Escheats are also incidental to the public function of regulating and controlling the succession to property, and if heirs are always found, the state gets nothing.

The meaning of the taxation revenues is set forth clearly in Bastable's definition of a tax. "A tax is a compulsory contribution from the wealth of a person or body of persons for the support of the public powers." The essential idea in this, and in Seligman's definition of a tax, is that of a compulsory levy for a public purpose.

The content of the remaining classes in the outline above will be clear enough. There may be some question as to whether the use of public credit really produces a public revenue, since the debt thus created must at some time be repaid. In the long run as much must go out as came in, and in order to meet the principal payments at their maturity the gov-

⁶ The reasons for regarding the fee and the special assessment as administrative revenues are, briefly, as follows:

In the case of the *fee*, which Professor Seligman defines as a "payment for a special measurable service, made by the individual for an advantage given," the idea is that, through various administrative agencies, the state renders special services to the individual, or under certain conditions confers an advantage upon him, for which the fee is the payment. In other words, the fee is the payment to cover the cost of an administrative service which the state performs for the individual. Theoretically the fee is based on the cost rather than on the value of the service rendered, but there is little disposition anywhere to maintain an accurate adjustment of the fee schedule to the current cost of the administrative services rendered.

The *special assessment*, which Seligman defines as "a payment made, once and for all, to defray the cost of a specific improvement to property," is also a charge to cover the cost of certain definite administrative responsibilities. It is the duty of the modern state, for example, to provide, or at least to assume administrative jurisdiction over, the system of highways and streets. The state or its local subdivisions may finance such improvements wholly from general funds, or from special assessments, or from both sources. If the improvement is deemed to be of such a nature that the advantage from it enhances the value of property adjoining, a special assessment may be imposed against the properties which have benefited. Here is the same fundamental idea of a special governmental service, which is being paid for by those to whom it is rendered, that is found in the case of the fee and other forms of administrative revenue. As was pointed out above, however, the special assessment contains a possible element of coercion not found in the fee. Some states permit city councils, by a substantially unanimous vote, to override the protest of property owners, and to order the construction of improvements which are to be paid for by special assessments. The assessment is levied and collected precisely as taxes are, and may become a lien against the property of the same character as the tax lien.

ernment is deprived during the life of the debt of as much as was anticipated and spent in a lump, together with an additional sum for interest. Unless the debt is of the perpetual form, like the French *rentes*, which need not be redeemed, or unless it is repudiated, it is correct that in the long run the true revenues consist of the taxes and other collections from the current income of the people. Public loans are simply a device for obtaining control, at a given time, of larger amounts of purchasing power for governmental use than is possible otherwise.

For this reason, however, it is desirable to set up the public loan receipts as a revenue. In view of the general practice, particularly among state and local governments, of financing improvements from loans rather than from current revenue receipts, no adequate understanding of the entire scope of their financial activities can be had without taking cognizance of their public debt operations. The total current and capital expenditures would always exceed the current revenue receipts and the inclusion of the loan receipts as a revenue serves, often, as an explanation of how the capital outlays were financed.

The Census Bureau's revenue classification. The Census Bureau distinguishes between revenue and non-revenue receipts, a distinction which is analogous to that made, on the expenditure side, between governmental and non-governmental cost payments.⁷ Revenue receipts are the amount of money or other wealth received or placed to the credit of the government for governmental purposes under such conditions that they increase the assets without increasing the debt liabilities or decrease the debt liabilities without decreasing the assets. The non-revenue receipts are those that do not result in an increase in the net value of the assets.

This classification of revenue items is less successful than that used for expenditures, despite the defects of the latter. Incongruous matters are grouped together and the detailed tables of the reports do not always provide the necessary data for more appropriate rearrangement. Thus, licenses and permits are all included with taxes, a proper procedure with respect to some business licenses, but one that is hardly correct for dog licenses, marriage licenses, building and plumbing permits and the like. The association of gifts and pension assessments is likewise incongruous, although the details are usually separately given in other tables.

The bureau's non-revenue receipts include the proceeds of loans, agency transactions, refunds, transfers and similar operations. From the standpoint of balance sheet accounting, and taking into account the redemption of the debt at maturity, it is correct enough to class loan receipts with transfers and similar items of a bookkeeping nature, as was recognized above. A true picture is not likely to result, however, of the amount and the sources of a government's expendable resources at a particular time.

⁷ Cf. Chapter III.

The organization of the sources of public revenue that is here suggested determines the method of subsequent presentation. In the present section are discussed the revenues that are derived from the commercial undertakings and the ordinary administrative activities. Part III is devoted to taxation, the most important of all revenue sources for the modern state. The discussion of public credit, in Part IV, follows logically after the consideration of the other sources of public revenue, since it will be used normally only after the other sources have been exhausted, or after they are deemed for any reason to be inadequate to provide the remainder of the necessary public funds.

CHAPTER XI

The Public Domain: Lands and Forests

THE GENERAL SUBJECT of this chapter and of the three that immediately follow, is the commercial or business activities of government. Viewed strictly from the standpoint of the amount of net revenue that these activities have supplied or are now producing, they would not be of sufficient importance to warrant as extended a discussion as is here undertaken. They offer, however, possibilities of increased net revenue at certain points; and the entrance of government into various lines of commercial activity presents some important questions of financial policy. Thus, the price policy and the standards of management adopted may result in surpluses available for general use, or in deficits that must be met from general taxation. Under certain circumstances, broad social considerations may overshadow all questions of financial outcome.

Some of the more important instances of government in business are reviewed briefly in order to illustrate the interplay of financial and social considerations. The present chapter deals with the government in the land business. Chapter XIII contains an account of some instances of federal and state-owned industries, while Chapter XIV concludes the survey with a summary of the commercial enterprises owned and operated by municipalities.

The federal government has been in the land business from the beginning. Diligent efforts to dispose of the public lands by gift or sale, and the toleration of frauds had greatly diminished the extent of its holdings and the economic importance of the remaining public domain by the end of the nineteenth century. Recent developments in agriculture and in reforestation have turned the tide, and there is some prospect that the public domain may grow, rather than shrink, in future. The public domain of certain states has also been expanding of late, under the new forest policy.

THE ORIGINAL PUBLIC DOMAIN

The thirteen original states became the joint possessors of a certain amount of wild, unsettled country by the terms of the treaty that ended the Revolutionary War. Since there were conflicting claims to some parts

of this land, because of the ignorance of or indifference to the facts of geography on the part of the various English sovereigns who had granted the colonial charters, and since there appeared to be no way of adjusting these conflicting claims, the difficulty was solved by ceding the bulk of these lands to the central government. They became, thereby, public lands, that is, lands belonging to the union of states, rather than to any state or to individual citizens. Lands thus owned by the federal government, representing the nation at large, are known as the public domain. When the new federal government was established it succeeded the confederation of states as the owner of these lands.

The area of the original public domain was 402,704 square miles. It extended from the thirteen states on the Atlantic seaboard to the Mississippi River, except for the Spanish possessions in Florida and the lands reserved by certain states for their own citizens. The remainder of the present territory of the United States was acquired under different treaties, beginning with the Louisiana Purchase of 1803 and ending with the acquisition of Alaska in 1867. A total of 2,484,220 square miles was thus obtained, at an aggregate cost of \$88,157,389.

Territorial rights have been acquired in different parts of the world since the Alaska purchase, but not all of these have involved additions to the public domain. The Hawaiian Islands were annexed in 1898 and in the same year Porto Rico and the Philippines were ceded by Spain. The sum of \$20,000,000 was paid to Spain for her claims to these islands. The Philippine Islands were formally declared independent on July 4, 1946. Time alone can tell whether they can keep what was given them. Part of the Samoan group in the South Pacific was acquired by treaty in 1899. After fruitless attempts to secure a canal right from Colombia the independence of the Republic of Panama was recognized in 1903 and the Canal Zone was purchased from the latter for \$10,000,000. Colombia was later given \$25,000,000 and an apology for the questionable haste which had been displayed in the recognition of the Panama provisional government in 1903. The Danish West Indies were purchased from Denmark in 1918 for \$25,000,000.

There was no question of territorial expansion involved, for the United States, in the second World War. Certain strategic bases were leased from Great Britain, and the final peace settlement will no doubt result in a transfer of various islands throughout the Pacific area. The objective in all such transfers would be more adequate national defense, and not territorial aggrandizement, now or hereafter.

FEDERAL LAND POLICY

The federal government has never had a public land policy, in the fullest meaning of this term. There has never been adequate understand-

ing either in Congress or among the people, of the kind of land program that would assure the most effective and durable utilization of the land and its resources. Much of the legislation has been determined by opportunism and expediency, reflecting the current changes of popular attitude toward this national asset. These characteristics of opportunism and expediency have not been limited to laws affecting the public domain.

In general, the public land program until the close of the nineteenth century emphasized alienation, or the disposition of the land to private owners. During the present century the emphasis has been increasingly upon conservation. These broad characterizations of policy are not mutually exclusive—conservation began before 1900, and alienation has continued since that time; but they indicate the outstanding contrasts of viewpoint in the history of the public land.

In recent years a broader conception of conservation has created some sentiment in favor of restoring land of little utility for agriculture to public ownership in order to promote reforestation, flood and erosion control, and better utilization of the agricultural land resources. To the extent that this program is executed, it would mean the establishment of an entirely new domain, not an addition to the original one; for the lands thus reverted to public ownership would not be subject to the mass of legislation relating to the original domain.

Land sales. The two matters of most concern in the beginning were promotion of settlement and provision of federal revenue from a non-tax source. Congress had no effective power of taxation under the Articles of Confederation, and there was, therefore, strong incentive to realize cash on this immense public asset. Sale of the domain had the support, also, of the economists of the time. Adam Smith had disapproved retention of public lands as a government resource, and had recommended application of the proceeds of sale to the redemption of the public debt. This view met exactly the requirements of Congress, which faced the responsibility of paying interest and redemption charges on the foreign loans made during the Revolution without adequate sources of federal revenue. It was hoped that the two objectives of sale and orderly settlement might be achieved, and with them, support of the foreign credit of the new government.

The sale policy was never very successful, because the people would not submit to the restrictions involved in orderly settlement.¹ The westward movement was irresistible and it would not wait for the surveyors. The people took possession of the land, confident that their acts of trespass would be lightly dealt with and Congress was obliged to reckon with this fundamental fact. Various expedients were attempted before the idea of selling the land in order to realize a revenue therefrom was finally abandoned.

¹ Cf. B. H. Hubbard, *A History of the Public Land Policies* (1924).

Quantity sales. The first was that of sale in large quantities at very low prices to the promoters of colonies or settlements. At least three such transactions were consummated before the Constitution was adopted.² Quantity sales were not successful, either in promoting rapid disposition of the public domain or in producing revenue.

The land problem was studied and reported upon by Hamilton, who placed the financial aim first, but suggested that regard should also be had for the accommodation of the settlers in the western country.³ His report served as a working basis upon which Congress established the machinery of survey and disposition of the public lands.

Credit sales. A second expedient was sale on credit. It had been suggested by Hamilton, and the legislation authorizing it was enacted in 1796. The credit system lasted until 1820. During this period the minimum quantity that could be purchased was reduced from a township to a quarter-section, and the minimum price was lowered to \$1.25 per acre. Sales on credit proved disastrous, since settlers were induced to spend their all in the initial payments. The amount owed to the government steadily increased, aggregating at one time \$20,000,000, and several acts were passed for the extension of credit terms and the relief of debtors. As is usual in such cases, relief really meant writing off the debt.

Cash sales. In 1820 a third expedient, sale for cash, was introduced, and the term *cash* was liberally construed to include the notes of solvent banks. This led to great speculation, both in banking and in the public lands, since the lands could be mortgaged as security for the bank notes that were given in payment. During the thirties the westward movement ran high. Receipts from western lands sales were \$15,999,000 in 1835, and \$25,167,000 in 1836. In the latter year came the famous "Specie Circular," which instructed land agents to accept specie only. The purpose of this order, according to the Secretary of the Treasury, was to prevent frauds against actual settlers by monopolists. It was proper to protect the Treasury against loss through acceptance of worthless bank notes, but the document was undoubtedly inspired by President Jackson's hostility to banks in general. The credit shock produced by this order was a contributory factor to the severe panic and depression of 1837-1839, and the sales of public land fell off to \$1,363,000 in 1841.⁴

² These were: (a) sale of 822,900 acres to the Ohio Company, headed by Manasseh Cutler (b) sale of 248,540 acres to John Cleves Symmes; and (c) sale of 202,187 acres to the state of Pennsylvania.

³ A. Hamilton, "A Plan for Disposing of the Public Lands," in *American State Papers on Public Lands*, Vol. I, p. 8 (No. 3). Hamilton's proposals included: (1) Sale of only that land to which the Indian title had been extinguished; (2) Reservation of sufficient tracts for the redemption of the public debt; (3) Sale of convenient tracts, not exceeding 100 acres, to actual settlers; (4) Sale in any quantity by special contract; (5) Reduction of the price to 30 cents per acre, payable in specie or in public securities.

⁴ Hubbard, *op. cit.*, p. 103.

Preëmption. The next stage was preëmption. It had been vaguely foreshadowed earlier, but was definitely reached in 1841. It means the right of the original settler to buy, at the established price and without competition, the land which he had settled on and improved. Land sales could not be concluded by giving and recording title deeds until the surveyors had established the base lines essential to a description and location of the property. The advance guard of settlers went far ahead of the surveyors, and the preemption policy gave the actual settlers, the first takers, the prior right to purchase the lands upon which they had settled, after the surveys had made acquisition of title a possibility.

The essential conditions of preëmption were the actual residence upon the land in a dwelling, and the cultivation of a certain portion of the holding. The preëmtor must be the head of a family, a widow, or an unmarried man over 21 years of age, a citizen of the United States, or if an alien, he must have filed a declaration of intention to become a citizen. He must not own in excess of 320 acres of land, and as a preëmtor he was entitled to acquire not more than 160 nor less than 40 acres of \$1.25 land. Five years' residence on and cultivation of the land were necessary before a deed would be issued.

The acceptance of preemption marked a definite change in the sales policy. Sales of large tracts had already been discontinued, and the maximum amount which one individual could buy had been gradually diminished. Preemption meant that actual settlers were to have the first rights of purchase, and it implied that the land was to be held for those settlers who were not already large landowners. The public land was to be held for the landless, who were thus encouraged to settle on it. The evolution of this attitude, under which the rôle of the federal government shifted from that of the large landed proprietor seeking to realize a quick cash revenue from sales, to that of the trustee holding vacant lands in trust for its landless citizens, was shaped in part by the political and economic events of the time. The antislavery interests desired speedy settlement by actual landowners, while the South opposed preëmption and other small ownership policies, since the slavery system could not readily expand into territory already filled with free white farmers.

The homestead, or free land. The logical development of the concept of trusteeship was the abandonment of the sales system in favor of an outright gift of sufficient land for a homestead to those who desired to settle on it. The homestead system had been advocated by various persons from the beginning of the nineteenth century, but it did not become a national issue until 1852, when the Free Soil Party declared for it. The enactment of homestead legislation proved not to be possible, however, until after the southern members withdrew from Congress at the outbreak of the Civil War.

The first Homestead Act was passed in 1862. The provisions of the

Preemption Act were repeated as to persons eligible, with the addition that such persons must not have borne arms against the United States. After five years of occupancy and cultivation a deed was to be given, on payment of the fees incidental to issuance of title. The settler had the privilege of commuting the homestead, as it was called, by exercising his right as preëmtor after six months occupancy and purchasing the land at the minimum price per acre. Lands thus acquired were never to be held liable for debts contracted prior to the issue of the patent.

The further details of the history of the federal land system are interesting and important, but they would run beyond the proper scope of this discussion. It is sufficient to say that as an offset to the increasing liberality which the federal government has displayed toward the landless settlers, a policy justified by the resulting stimulus to western settlement and by the rapid growth of wealth throughout the country, there has been great laxity in framing effective provisions for the prevention and punishment of frauds against the whole people, committed by those who were obtaining large quantities of lands and the resources contained therein without adequate recompense. This indifference is not easily justified, and the slackness in dealing with those who were plundering the domain is without excuse. While the homestead system was opening up to occupancy the vast land resources that were being held for the entire nation, Congress was abandoning the whole principle of trusteeship by its neglect and its indifference to the ease with which frauds against the domain were committed.

Professor Hibbard summarizes the results and the shortcomings of the Homestead Act as follows.⁵

The great weakness of the Homestead Act was, and is, its utter inadaptability to the parts of the country for which it was not designed. The idea of the farm small in acres within the semi-arid regions was tenacious, but untenable. It was even vicious in its operation. Congress was converted to the homestead principle in the large, and instructed in detail, by the people on the Missouri River frontier, backed up by the experience of the whole country, not essentially different, between Ohio and the Missouri. The frontiersmen on the plains were too few in numbers, and too unlike the earlier frontiersmen to the East of them, to compel the working out of a desirable modification of the land laws. The recent acts are improvements over the earlier ones in their application to the semi-arid states. So far as the operation of the Homestead Act in relation to forests is concerned there is hardly a mitigating feature. It was wholly inapplicable, yet it applied. It promoted perjury and profits among a large number of small adventurers. The forests were easily procured by the lumbermen and are now largely gone. In this tragedy the Homestead was a mere incident.

With all its shortcomings the Homestead Act clearly has more to its credit than any other land act passed by the federal government. A million and a third homesteads have been taken up and carried to completion. Many

⁵ *Ibid.*, p. 409.

failed to become farms, yet out of the number the majority remained the farm unit for some years. It was a means of peopling the wilderness, and while it was a short-sighted policy, leaving many land questions unsettled, the hope of their settlement in advance was entirely wanting. East of the hundredth meridian the Homestead Act was a success.

An illustration of the indifferent attitude of Congress is found in the failure to repeal the preemption laws when the Homestead Act was passed. These laws were not repealed until 1891, and in the meantime they favored the concentration of large tracts of forest land into the hands of private interests. The commutation privilege under the Homestead Act operated in the same direction, and the extension of the period of residence before commutation to fourteen months in 1891 checked but did not eliminate the speculative filing on public lands which was part of the land grabbing movement. The Timber and Stone Act of 1878 also fostered timber grabbing, since it was possible for large numbers of dummy entries to be made on the timber lands, and then assigned to private interests.⁶

The idea of the homestead, that is, of a small tract on which a family unit might make a living, died hard, despite the mounting evidence that this was physically and economically impossible throughout much of the western plains country. In 1910 the homestead minimum was raised to 320 acres, and as late as 1916, to 640 acres, or one square mile. A section of land will amply support a family in regions with sufficient rainfall to permit tillage, but it is entirely inadequate if grazing must be the chief source of family income.

The fruits of the short-sighted, speculative land policy under the Homestead Act as it operated in the semi-arid regions are now being gathered at great expense. The attempt to cultivate lands not suitable for agriculture, due to lack of moisture, except in about one year in five, destroyed the native grasses and depleted the local underground water, which was sufficient for the indigenous vegetation, but far too little for crops. The competition of such sub-marginal land was nevertheless sufficient to force wasteful tillage of much land normally suitable for agriculture, or to prevent its proper maintenance through low returns. Thus it has contributed to, if it has not wholly produced, the costly farm relief problem. Meanwhile, wind erosion of the loose top soil of these areas that should never have been plowed provided the great dust storms of 1934 and 1935, with their grim prophecy of the new American desert.

Land grants. Another method of alienation has been by giving lands as subsidies or bounties for various purposes. Three of these purposes stand out as of chief importance. They are (1) bounties to soldiers, (2) gifts to states in aid of education, and (3) subsidies in aid of internal improvements, notably railroad construction.

⁶ Hibbard, *op. cit.*, pp. 465-469.

The policy of giving land for military service was inaugurated during the Revolution, when land bounties were offered for enlistment and as a means of inducing desertion from the British army. Similar bounties were given for enlistment in the War of 1812 and the Mexican War. To June, 1880, a total of 61,028,430 acres had been given away for military and naval service.⁷

The principle of giving land in support of education had become well established during the colonial period.⁸ The act which admitted Ohio in 1803 granted one section in each township for common school purposes. Subsequent legislation increased this grant to two sections in 1848, and to four sections in 1910. The earlier states were permitted to sell their lands and most of them did so, realizing but a small sum for the support of education. In the Colorado Enabling Act of 1875, Congress introduced restrictions on the price at which school lands could be sold, and required that the principal sum realized should be held permanently to provide an income for educational uses. Later enabling acts added other safeguards about the manner of investment of this permanent fund. In addition to these automatic school land grants, certain saline and swamp lands have also been given to the states for school purposes. The aggregate grants for common schools have amounted to 73,155,075 acres.

This method of granting land to the states prevented efficient land utilization and control, for the states' holdings were automatically scattered among the private holdings. They usually had no alternative but to sell, and extremely low prices were often received. A system of exchange that would have permitted the states to consolidate their holdings would have enabled them to experiment with a rental or leasing system, which is the most attractive method of state management. At any rate it might have encouraged them to wait for higher land values before selling. Provision for such exchange and consolidation of the states' school lands has now been made, but it has come too late to be of benefit except to a few of the western states.

The states have also been given lands in support of higher education. The Morrill Act of 1862 gave to each state 30,000 acres for each senator and representative. The act stipulated that the money realized from sales should be invested and the income therefrom used to support at least one college, the leading object of which was to be instruction in such branches of learning as are related to agriculture and the mechanic arts.

Land grants in aid of internal improvements were also inaugurated in the Ohio Enabling Act of 1802, which provided that 5 per cent of the proceeds of public land sales in that state should be given for building public roads. The question presently became a political issue, and in time

⁷ Veterans are favored in land allotments today. Canada and Australia have adopted a similar preferential treatment of veterans.

⁸ Hibbard, *op. cit.*, pp. 465-469.

The tremendous pressure for railroad building in new and undeveloped sections as well as in the older sections of the country led to a strong demand for federal land subsidies as an aid and an inducement to construction. The constitutional and political objections to giving land in aid of internal improvements were met by giving land to the states, with the understanding that the states were to give it to the railroad companies. The center of this opposition was in the South, so the railroad land grant policy did not really get into full swing until after the outbreak of the Civil War. Beginning with the Union Pacific land grants in 1862, Congress entered upon a steadily more liberal program of direct grants, chiefly to western and transcontinental lines. The states received a total of 37,789,169 acres, and railroad corporations a total of 91,239,389 acres, a grand total of 129,028,358 acres for railroad purposes.¹⁰

The present attitude toward the public domain favors conservation as decidedly as that of the nineteenth century favored alienation. President Theodore Roosevelt and some public-spirited citizens of his time gave great impetus to the movement, although the need of a more careful use of the resources of the public domain had already been realized by some, and a beginning had been made in appropriate legislation. The conservation movement has found expression in three ways: (1) by withdrawal of lands containing forests or other resources from entry; (2) by reclamation; and (3) by the acquisition of lands from private owners, in the interest of reforestation or revegetation, or of flood and erosion control, or of a resettlement of the farm population.

Withdrawal. Withdrawal from entry means the withdrawal of the privilege of entering the public domain and filing a claim under the Homestead Act, a procedure that would normally lead eventually to issuance of title to the occupant. The first withdrawal act was passed in 1891. Hibbard characterizes it as “the most signal act yet performed by Congress in the direction of a national land policy.”¹¹ Its significance

For wagon roads	3,276,646	acres
For canals	4,598,668	acres
For river improvements	2,245,252	acres

Total 10,120,566 acres

¹⁰ *Ibid.*, p. 264.

¹¹ *Ibid.*, p. 532.

lies in the fact that it has provided a means of checking the ruthless seizure and exploitation of the remaining resources of the public domain.

The power of withdrawal was exercised first in the case of forest lands, and later, beginning in 1905, in the case of coal lands and other lands known or believed to contain deposits of minerals, metals or oil. With respect to mineral lands that may be suitable for agriculture or grazing, the prospecting and mining rights have been reserved and the surface rights have been opened for entry. Provision is made for compensation to the owner of the surface rights for damages caused by prospecting and mining operations.

The inauguration of a conservation policy by withdrawal came too late to save the forests, as Hibbard points out, for a large part of the timber on lands unsuited for agriculture had already been cut or had been acquired by questionable and even fraudulent means during the period when the government and the people were indifferent to this kind of spoliation. It came too late also, so far as concerns a large part of the underground resources, although the existence of such resources was frequently unknown and unsuspected at the time the land was alienated, and there was therefore much less of obvious fraud in its acquisition. It has been the misfortune and the hard luck of the American people that the distinction between surface and underground rights was less familiar in English and American law than it was in the law of other countries. The German Cameralists spoke of the *Bergregal* or regalian right to mines or the product of mines. The Spanish kings claimed title to all gold and silver deposits in their possessions; and of all metal mined, one-fifth was for the royal treasury. Mexico's action in reserving for the state the title to all minerals, metals and other valuable underground deposits, in the constitution of 1917, was in complete accord with the theory and history of Spanish law on this subject.¹²

Vigorous exercise of the withdrawal policy began anew in March, 1929. The issue of new permits to prospect on oil and shale lands was suspended, and during the next three years 16,000 permits were canceled for failure to comply with the land law requirements. This was a house-cleaning process, designed to weed out speculative activities during a period of overproduction in the oil industry. It is now possible, in giving new permits, to stipulate for unit operation of the geological structure under an orderly plan.¹³

A final step was taken in 1934, when the President, by executive order, withdrew from entry all lands remaining in the public domain. This had

¹² *Constitution of Mexico*, 1917, Art. 27. Cf. C. L. Jones, *Mexico and Reconstruction* (1921), pp. 255, 257, 258. The same is true of the mineral reservation provisions in the Philippine constitution of 1935.

¹³ *Annual Report of The Secretary of the Interior*, 1932, pp. 28, 29. In his annual report for 1930 (p. 13) the Secretary had said that the oil conservation policy of 1929 had resulted in blowing a great deal of speculative paper off the public domain.

been the goal of the General Land Office for years¹⁴ but its proposal stimulated counteragitation to surrender all remaining lands to the states. The withdrawal, in effect, suspends the homestead law, and it may mean the termination of this chapter of the public land history. In the same year Congress passed the so-called Taylor Grazing Act,¹⁵ authorizing the designation of not more than 80,000,000 acres of the public domain as grazing lands and the controlled use of these lands for grazing purposes under locally constituted grazing districts. This is an immensely important step. It is a belated move toward the conservation and restoration of the grazing resources of a region in which grazing is the most important economic pursuit. Federal indifference toward the destruction of the natural vegetation through overgrazing has been thorough and prolonged. In consequence, the carrying capacity of the range has been greatly reduced and its rehabilitation will be a long, slow process. This act is a beginning in the right direction.¹⁶

The story of the disposition of the public lands is compactly but clearly told in Table XV, which summarizes the amounts disposed of in various ways, and the amounts which still remain in the possession of the United States, as of June 30, 1935.¹⁷

¹⁴ *Ibid.*, 1925, pp. 5, 6.

¹⁵ *United States Statutes*, Vol. 48, p. 1269.

¹⁶ The director of the grazing division gives the following picture of the significance of grazing for the region affected. After indicating that the remaining area of the public domain embraces some 165,000,000 acres in ten states, he adds:

"The question naturally arises as to why all these lands are where they are, and why they have been the left-overs from seventy-five years of selection by homesteaders, State Land Boards, and other forms of entry or selection. The answer is that this area practically all falls within the fifteen-inch isohyetal line, that is, the line which encircles that part of the West which receives less than fifteen inches of rainfall annually. It is an area of some 500,000,000 acres, or nearly thirty per cent of the total area of the United States. By the very nature of its climate it is a separate region agriculturally from the rest of the country. Within it lie all of the states of Nevada, Utah and Arizona, and parts of the states of California, Colorado, Idaho, Oregon, New Mexico, Montana and Wyoming. Only two and one-half per cent of this area is cultivable, and the greater part of that small portion of crop land has to be artificially irrigated. Twelve per cent of the area is timber land and not susceptible to grazing, but the balance, or 85.5 per cent, is either grazing or waste land. . . . In extent of area, grazing is the predominant industry of this region. Three-fourths of all the crops raised within the region are consumed by livestock, and only one-fourth exported to the rest of the country in the shape of sugar, cotton, wheat and a few minor crops. Coal and metal mining and oil production are carried on in certain small areas but do not change the predominant industry. Ten million cattle or fifteen per cent of all cattle in the United States, and 25,000,000 sheep, or 48.6 per cent of all sheep in the United States, pasture in this region. Very little or no industry is carried on with the exception of mining, and all the cities and towns of the entire area combined do not have a population of 1,000,000 people. The population outside of the cities, which will total under 2,000,000, or three to the square mile, is less than two per cent of the total population of the United States, although utilizing over twenty-five per cent of its area."

Farrington R. Carpenter, "Grazieri a Science," in *The Utah Juniper*, Utah State Agricultural College, Logan, 1935.

¹⁷ Data supplied by the General Land Office.

TABLE XV

DISPOSITION OF THE PUBLIC DOMAIN AS OF JUNE 30, 1935

	<i>Acres</i>
Title passed from the United States:	
Homesteads (approximate)	276,767,000
Cash sales and miscellaneous disposals (approximate)	418,229,000
Railroad grants to corporations	94,229,591
Railroad grants to states	38,207,706
Wagon road grants to states	3,359,188
Canal and river improvement grants to states	6,842,921
Swamp, educational and other grants to states	181,682,198
<hr/>	
Total area disposed of	1,019,317,604
Pending and unperfected public land entries.	19,666,693
Title remaining in the United States:	
National forests	138,710,947
National parks and monuments	8,724,732
Indian reservations (estimated net)	57,518,590
Military, naval and similar reservations	1,000,000
Withdrawn	197,261,754
<hr/>	
	403,216,023
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Total area of the original domain	1,442,200,320

As of 1944 the total lands in federal ownership, exclusive of the territories, were 455,183,251 acres. About 91 per cent of this area was in the public domain. The remainder had been acquired by purchase, gift, or condemnation. Under the Transportation Act of 1940 railroad companies have surrendered 8,320,446 acres of land originally granted to aid railroad construction.¹⁸

The United States retains title to about 28 per cent of the original area of the domain. The case for holding much of this remainder seems fairly clear. The national parks, the Indian reservations and the military reservations require no discussion. Withdrawal of the remaining open range from entry was the only way by which its use could be controlled and its carrying capacity restored. There are equally compelling reasons for continued public ownership of the national forests. Among these are (1) conservation of the timber supply, (2) development of scientific forestry methods and practices, and (3) controlled use of the forest areas for timber-cutting and grazing. Private forest ownership tends to neglect all of these factors, since the viewpoint is naturally that of realizing the early, quick profits to be had from ruthless cutting, followed by abandonment of the cut-over area. The conditions thus created are favorable to destructive fires which hinder reforestation by loss of the humus cover and erosion of the top soil.

¹⁸ House of Representatives, Committee on Public Lands, *Interim Report* No. 1884, 78th Congress, 2nd Session, September 14, 1944.

Reclamation. A second way of achieving the conservation goal is by reclamation, which is the process of making land suitable for agriculture or other uses by irrigating, draining, filling, grading, or other appropriate treatment. In the general sense reclamation has been going on for a long time. Extensive swamp areas have been drained, the Back Bay district in Boston and the lake shore park system in Chicago were created by filling shallow, flooded areas. The particular form in which the term *reclamation* captured the imagination of the country in the opening years of the present century was that of great irrigation projects in the arid region of the West. A less well-advertised but fundamentally far more important application of the same idea is in the recently inaugurated erosion control service.

The reclamation service was established in 1902. A portion of the receipts from the sale of public lands was set aside as a reclamation fund, and to this fund were added, later, the potassium royalties and rentals, 52½ per cent of oil and mineral royalties, and the proceeds of federal power licenses. The money thus accumulated has been used to finance construction of dams and irrigation systems. Upon completion of a project, the irrigable land is open for sale to settlers on a basis that is assumed to eventually return the capital cost of the undertaking, without interest, together with costs of operation and maintenance. If the irrigation district thus formed includes privately owned lands, the owners thereof are required to contribute toward the construction and operation costs at charges per acre fixed by the Secretary of the Interior. Districts composed entirely of privately-owned lands may be formed and a contract entered into with the United States for the construction of an irrigation system.

The reclamation program has undergone extensive change since its inception. The original purpose was irrigation, and the original tillage prospects involved principally grain and forage crops. The power possibilities of the earlier dams built were given little attention. Today these possibilities are being canvassed and increasing effort is being made to utilize them, both for the irrigated district and for other users. The agricultural activity is shifting from wheat and hay to orchards and truck garden crops, which require more water and a longer season of irrigation. In addition, the demand for water from the cities on the Pacific coast and elsewhere, has been growing. Consequently, more elaborate and more expensive construction is involved, and the pressure on the reclamation fund has increased. The charges against the land susceptible of improvement through irrigation have risen from \$25 to \$50 in the beginning to a range of \$75 to \$200 per acre. Power revenues are relied upon to offset part of this increased cost, and the Secretary of the Interior has suggested, as another source, contributions from cities and areas benefited by resulting flood protection, although any kind of assessment

upon these areas for such protection would be extremely difficult of administration.¹⁹

The Bureau of Reclamation recommends that the net power revenues should be applied, first, to the construction cost of the power system, second, to the cost of the dam, and ultimately, to the reclamation fund. On the other hand, the property owners of the several districts, appreciating the future possibilities of the power revenues, have demanded that the power systems be transferred to the respective districts. The bureau's position on this subject seems sound. Public land sales have provided, thus far, 70 per cent of the entire reclamation fund, but little more can be expected from this source under the new land policy. Unless the profits from the power business go into this fund in future, either the reclamation movement must slow down materially or funds for further construction and development must come from the general public pocketbook.

At the end of the fiscal year 1944 the total federal expenditure on reclamation projects was \$921,771,000. Of this amount \$402,355,000 was reported as expenditure on special projects in the reclamation field, such as Boulder, Grand Coulee, and other power and irrigation construction. The remainder, \$519,416,000 had gone into regular reclamation projects. Even this amount, however, was much in excess of the total funds that have been received by the Reclamation Bureau from the sources assigned to it. A summary of the receipts and disbursements of the reclamation fund from its beginning to 1944 is given in Table XVI.²⁰

TABLE XVI

TOTAL ACCRETIONS TO AND DISBURSEMENTS FROM THE RECLAMATION FUND, 1902-44
(THOUSANDS OF DOLLARS)

Total accretions	
Sales of public lands	\$113,234
Oil leasing act	75,259
Naval oil reserves	29,778
Potassium royalties	1,678
Water power licenses	961
Sub-total	\$220,910
Collections—construction, operation and maintenance, water rentals, and power	159,748
Total cash receipts	\$380,658
Total disbursements charged to reclamation fund....	349,523
Balance	\$ 31,135

¹⁹ *Annual Report for 1930*, p. 20.

²⁰ Compiled from the *Annual Report of The Secretary of the Interior*, 1944.

In the early optimism of the movement it was expected that the fund would "revolve" rather frequently, and the first contracts were written on a ten-year basis. This was obviously impossible, and the terms of repayment have been adjusted on a more reasonable basis. The status of the accounts, shown in Table XVI, indicates that after more than forty years, the fund has only revolved once. The slow rate at which the landowners are able to pay off the capital charges incurred in improving the lands by means of the reclamation works indicates that restraint must be practiced in further development. The reclamation expenditure, for the purpose of improving lands otherwise suitable for agriculture, is defensible to the extent that the values thus created are sufficient to meet the costs involved. Substantial values other than agricultural have of course been created. Cities and towns have grown up to supply the reclaimed areas and the local taxable resources have been thereby increased. As of 1943 the Bureau of Reclamation reported 68,230 irrigated farms with a farm population of 252,663, and a population of 906,345 in towns on or tributary to the projects. There were 1,207 schools, 1,514 churches, and 139 banks having total deposits of \$517,902,000 owned by 388,975 depositors.²¹ While these gains are important, they do not justify depletion of the reclamation fund by cancellation of, or prolonged delay, in settling the original construction accounts. They do suggest the propriety of spreading more widely the burden of construction and operation. This will be accomplished in part by the application of the power revenues to construction costs. The Bureau of Reclamation has emphasized increasingly the desirability of economic surveys of the projects now in operation with a view to appraising the results, spreading the burdens and improving the planning for the future.

The problems of management and operation have proved far more difficult of solution than the strictly engineering problems of construction, serious as the latter have been. The settlers, like all other beneficiaries of government, have continually sought greater concessions and advantages, and the three-cornered problem of coöperation, involving the federal government, the states, and the groups of citizens on the projects, has not always been dealt with smoothly. On the whole, however, the undertaking has been of great value to the West, and has added materially to the wealth of that region. It has promoted the utilization of natural resources, which is the goal of all conservation.

The acquisition of land. The latest development of the conservation movement actually reverses the first phase of the public land policy, for it involves the acquisition, rather than the alienation of land by the government. It means in one sense the building of a new domain, although it does not mean that the lands to be acquired will ever be subject to the laws and the privileges applicable to the remaining portion of the

²¹ *Ibid.*, p. 26.

original domain. Much of the land to be acquired has been cut over, or mined or farmed out, and private ownership, in view of the taxes, is no longer profitable. The new domain that is beginning in this way is in painful contrast, from the standpoint of resources, with the same lands at the time they were separated from the original domain. Although these lands have been squeezed hard, their utility has not been wholly destroyed, except for some tracts on which erosion has entirely removed the top soil and has rendered extremely difficult the planting of new vegetation. The task of this phase of the conservation movement is the restoration of these lands by methods appropriate to the region in which they occur. It involves bringing back the logical and natural type of vegetation, forest, grass or thicket, establishment of the conditions most favorable for the growth of the new permanent crop, and careful, controlled use of the land, whether for grazing or harvesting the timber crop as it matures.

The new land program, as now administered, is closely related to the major problem of rural relief that emerged during the depression.²² The first stage in dealing with rural relief was attempted rehabilitation in place, by loans to provide livestock, seed and equipment. But this method was both costly and relatively futile, since there was found to be a close correlation between the need of relief and the unsuitability of the land occupied for the permanent and successful conduct of agriculture.

Rural resettlement. Rehabilitation in place accordingly gave way to rural resettlement. The federal government offered to relocate farmers who had become stranded on sub-marginal land, by purchasing other land considered to be more suitable for successful agriculture. In effect this involved an advance of the capital required for a fresh start under more favorable conditions, as the newly acquired land would be leased to the occupant or sold to him on manageable terms. Resettlement was voluntary, presumably, but would be accepted by a large proportion of those to whom the opportunity was offered.

More appropriate land use. Land areas that could thus be cleared of the stranded farm population and other areas which had been largely abandoned after the original fertility had been exhausted, are to be acquired and put to other appropriate uses than agriculture. So-called sub-marginal land is seldom wholly useless. The term has been used chiefly to describe agricultural lands on which the crop return does not cover the cost. Land not profitable for agriculture can be reforested, set aside for wild-life preserves, used as recreation areas if near large cities, or adapted to other appropriate uses. The discovery and application of such appropriate use is the essential objective of this phase of the conservation movement.

²² Cf. *Hearings before a Special Committee on Survey of Land and Water Policies of the United States*, pursuant to Senate Resolution 58, Part I, August 28, 1935.

It is somewhat complicated by the instability of any sub-marginal classification, which depends on the price as well as on the yield of the crop. Yet there are always possibilities of alternative uses that would be more advantageous than agriculture, and there is above all the need of salvaging run-down, worn-out, eroding lands that are now relatively unfit for permanent agriculture and which are, in the existing agricultural outlook, relatively unnecessary for crop uses.

Despite the complications that may arise, this development is of tremendous significance for the whole country, not only from the standpoint of the financial values preserved and created through the rescue of neglected land resources, but also from the standpoint of its bearing on agriculture, on the structure and finances of local governmental units in the areas most deeply involved, and on the recognition of the need of a long-range land policy.

Both the states and the federal government appear to be committed to this type of land program. Some states had begun, years ago, to create state forests in mountainous areas, and they had inaugurated reforestation as the best means of salvaging land once devoted to tillage but abandoned in face of the competition of the fertile lands in the great inland valleys. Flood and erosion control, water supply, and the possibility of reorganizing local areas to eliminate costly local services were additional motives. Other states have had a similar problem thrust upon them by wholesale tax delinquency after the original forest had been cut. The creation of the Civilian Conservation Corps, as a means of providing relief and employment to young men, gave further impetus, and many states proceeded to acquire lands for state parks and forests under the inducement provided by the opportunity of road-building, reforestation, erosion control, and other conservation activities therein.²³

Much attention has also been given to the question of land use and land classification. State planning agencies have begun to make inventories of their lands and have discovered some rather surprising facts in consequence. The National Resources Board has outlined a general policy of land use which contemplates, eventually, a considerable addition to the lands now publicly owned. These recommended extensions of the new public domain are summarized on page 166.²⁴

In addition, the board recommends the retirement of about 75,000,000 acres of sub-marginal land from agriculture, but some part of these lands would pass into one or another of the categories given in the above summary. Various federal and state agencies are now engaged in the development of detailed plans for rural settlement and rehabilitation, for

²³ Paul W. Gates, "Land Acquisitions by the States," *Land Policy Review*, February 1935.

²⁴ National Resources Board, *A Report on National Planning and Public Works in Relation to Natural Resources*, etc. Part II, *Report of the Land Planning Committee*, p. 236.

compiling more complete data relative to all land resources of the nation, both privately and publicly owned, and for dealing with the multitude of problems that has arisen.

SUMMARY OF AGGREGATE AREAS PROPOSED FOR FEDERAL AND STATE ACQUISITION
(MILLIONS OF ACRES)

<i>Purpose</i>	<i>Federal</i>	<i>State</i>
Parks	22.7	7
Specialized wild life refuges	38.0	2
Forests	131.0	52.8
Indians	25.0	..
Total	216.7	61.8

The most satisfying and encouraging aspect of this movement is the fact that both government and the people are on the way to becoming land conscious. Renewed interest in the land opens the way to correct some of the mistakes of the past. Amid all the activity and enthusiasm other mistakes have been and will be made, such as the proposal to plant a belt of trees from the Canadian to the Mexican boundary in a section where trees could not possibly survive. But these mistakes should not prevent achievement of the main goal, which is the preservation of the basic resources of the land.

This aspect of the conservation movement may in the end mean a greater cash outlay than has gone into reclamation. It will be in substantial degree a reproductive expenditure for the long run, however, and the indirect social advantages that are in prospect will far more than justify that portion of the expenditure which is not directly returned from the conversion of lands to more efficient uses than they have at present.

Soil conservation and development. The new land policy was given an unexpected and unfortunate political turn in 1936, by the enactment of the Soil Conservation and Domestic Allotment Act. The Supreme Court had rejected the method of subsidizing agriculture introduced under the Agricultural Adjustment Act of 1933, and a law of 1935, relating to soil conservation and erosion control was selected as the new vehicle for subsidy purposes.

The choice was regrettable, for it necessarily gives to a long-range problem of vital importance, namely soil conservation and erosion control, a political, hand-to-mouth significance that must eventually react most adversely. The emphasis on conservation and erosion control is likely to be regarded as insincere, since the obvious purpose is that of continuing the farm subsidies, for which a maximum annual appropriation of \$500,000,000 is authorized. It is unwise and in the long run disastrous

to couple the future of a genuine conservation measure with that of a subsidy program of temporary significance. Soil conservation is thus inextricably bound up with the purposes of the subsidy. It becomes merely a means to an end, and is no longer an objective that is, in itself, of the most vital importance. If and when the purpose of the subsidy is accomplished, soil conservation is more than likely to be cast aside as having fulfilled its usefulness.

The act continues the inherent contradictions of the earlier law. Its main purpose is the following:

Re-establishment, at as rapid a rate as the Secretary of Agriculture determines to be practicable and in the general public interest, of the ratio between the purchasing power of the net income per person on farms and that of the net income per person not on farms that prevailed during the five-year period August, 1909-July, 1914, as determined from statistics available in the United States Department of Agriculture, and the maintenance of such ratio.

At the same time, the act provides that the powers conferred by it shall not be used for the following purpose:

...to discourage the production of supplies of foods and fibers sufficient to maintain normal domestic human consumption as determined by the Secretary from the records of domestic human consumption in the years 1920 to 1929, inclusive, taking into consideration increased population, quantities of any commodity that were forced into domestic consumption by decline in exports during such period, current trends in domestic consumption and exports of particular commodities, and the quantities of substitutes available for domestic consumption within any general class of food commodities.

Finally, the act provides:

In carrying out the purpose of this section due regard shall be given to the maintenance of a continuous and stable supply of agricultural commodities adequate to meet consumer demand at prices fair to both producers and consumers.

The bare enumeration of these provisions indicates the amazing amount of guesswork and arbitrary action that will be required on unknown or incomplete data. Consider the first requirement. Does anyone know, or can anyone now discover what was the ratio between the purchasing power of farm and non-farm net income in the supposed "golden age" of agriculture, 1909 to 1914? The answer is "no," yet by a species of statistical legerdemain an alleged ratio will be produced. Then the second requirement forbids diminution of production below the normal level of consumption in the years 1920 to 1929, as modified by various conditions and trends. It is permissible to express grave doubt as to the reliability of any statistical measurements under this provision, in view of the interaction of one trend or tendency on another. Without doubt

some figures will be produced, since the act requires that they be produced, but they will necessarily be of dubious validity.

Finally, none of these manipulations must cause the consumer to pay more than, or the producer to receive less than, a fair price. What is a fair price for pork chops, or bread, or a crate of oranges? Must the Secretary of Agriculture control the operations of the legitimate middlemen and the racketeers in milk, poultry, artichokes and other lines of distribution in order to keep down retail prices while raising farm prices for food stuffs?

This act, like its ill-fated predecessor, sets a series of inconsistent, and on the whole impossible, goals. They cannot be entirely reconciled, but, that, after all, is not important, since their achievement would eliminate the necessity of further subsidy. The amount authorized is purely arbitrary. It may be more than enough, or less than half as much as is needed to effect the equalization of incomes. A less amount would hardly suffice to go around, while the taxpayers would no doubt object strenuously to a very much larger total. The figure is probably a happy choice for the best political results, and this, of course, is the primary concern of both major parties in the farm relief problem.

Suburban resettlement. Another aspect of the basic land and population problem is provided by the effort to bring about decentralization of population through the establishment of new, small communities, with living conditions superior to those available in congested centers. The National Industrial Recovery Act of 1933²⁵ authorized the use of \$25,000,000 to aid, by loans or otherwise, in the purchase of "subsistence homesteads." Since suitable suburban subdivisions, already improved and awaiting tenants, were not available except at sale or rental prices that were prohibitive for small-income families, it was necessary to plan and construct such communities. The original design of transferring families from overcrowded large cities was not consistently followed, for more than half of the projects approved were in the southern and western states. The standard was evidently shifted from decentralization to the construction of low-cost, model housing projects in different parts of the country, possibly for demonstration purposes. The money collected in repayment of the loans and advances was to be used as a revolving fund for further, future development.

As used here, the term *homestead* did not mean a farm of 160 acres, as it did in the original Homestead Act of 1862. It was interpreted to mean a house and a small plot of land, usually two to five acres, on which a family could supplement the wage earnings from industrial employment with the real income derived from a garden, cows, pigs, chickens, and other sources of food supply. It was designed to demonstrate that full or part-time wage work could be profitably combined with part-time farm

²⁵ 73rd Congress, 1st Session, *Public No. 67*, Section 208.

and garden work, to the enhancement of the family standard of living.

None of these projects was successful from the resettlement point of view. They failed to draw and hold industries and they could not for long hold the type of resident for whom the program had been conceived. The government's interest in Arthursdale, West Virginia and in Jersey Homesteads, New Jersey, has been closed out by auction sales which in each case netted only a few cents on the dollar of original cost.

CHAPTER XII

The Industrial Domain: Some Matters of General Policy

THE TERM *industrial domain* is used here in a generally inclusive sense, to include all of the types of economic enterprise owned and operated by government, although many of these are, strictly defined, commercial rather than industrial in character.¹ Central and local governments alike have invested in various types of enterprise as a means of broadening the scope of their services or for other reasons. In this chapter some of the questions of general policy, such as the motives for public ownership and operation of commercial enterprises, and the standards of management to be observed, will be briefly reviewed.

GENERAL MOTIVES FOR PUBLIC OWNERSHIP

The reasons for any particular governmental venture into the industrial field will always be in considerable degree specific and local. There are, however, some general considerations that, singly or in combination, have been influential.

Lack of private capital. One of these is the fact that the government is frequently the only agency capable of providing the necessary capital, or willing to assume the risks involved. The pressure for early railroad construction in Australia is a case in point. The need for communication was so great and the private capital resources of the new settlements were so limited, that the state was compelled to build the railroads. The federal government built the Panama Canal after private enterprise had failed. Seattle built a great power plant in the Cascade mountains, when private interests refused to assume the risks. In some countries the low state of private initiative and enterprise and the habit of reliance upon governmental leadership have contributed to the development of the policy of public ownership. Bastable observes that state manufacturing for public use is more likely to be found in backward countries, or in the earlier stages of industrial development, and that it should tend to decline with general industrial progress. This, he adds, is true of public industry in general, since the government of an undeveloped country might right-

¹ Cf. the analysis of the concept of the domain in J. Caillaux, *Les impôts en France* (1910), Vol. I, pp. 378-382.

fully undertake works that would be uncalled for in more advanced nations.

The tendency to monopoly. A second motive for public ownership is presented by the problem of monopoly. The well-established tendency of municipal utilities toward monopoly has been urged as a compelling reason for public acquisition of these undertakings. The experiments in the public ownership and operation of the terminal elevators, flour mills and banks in North Dakota were inspired by the popular belief that only in this way could the control of outside interests over these fundamental industries be checked. The North Dakota experiment did not immediately involve a complete state monopoly in these fields, but it was an effort to break the monopoly control of concerns located outside the state. In other instances nations have resorted to a public monopoly of certain industries, or of the production and sale of certain commodities, for purely fiscal purposes, as in the case of the French tobacco monopoly, the Italian salt monopoly and the vodka monopoly which the former Russian government once exercised.

Conservation. A third motive is the desire to promote the conservation of natural resources for the whole people. The federal government has set aside from the public domain great forest tracts which are managed by the forestry service. The program of federal and state acquisition and management of lands that was outlined in the preceding chapter is an expression of the conservation movement.

Strategic advantage. A fourth motive for public ownership that has been significant in some instances has been military and political strategy. The German states were influenced by this factor in acquiring their railroad systems, and in the subsequent policy of construction and operation military expediency always weighed more heavily than commercial and economic advancement. Many of the Indian railroad lines were built, either with regard to the situation at the frontier, or as a means of preventing famine by assuring more adequate distribution of food products, rather than from the standpoint of profitable railroad undertakings. The political advantages of controlling the potash deposits were a factor in the acquisition of this resource by Prussia. It has always been regarded as a sound political maxim that a nation should build up within its borders the means of national defense. Ordinarily these means have been provided, in modern times, by private capitalists, who have not infrequently been subsidized by the state, but there have been many instances of public ownership which have been inspired by this motive. The federal government built a large fleet during the first World War and was in the shipping business for some years thereafter as a result. It built a power plant at Muscle Shoals, and after standing idle for some years while Congress debated, it has become a powerful economic and political weapon in the contest over electric light and power rates.

Welfare services. A fifth motive for public ownership has been the need of providing certain welfare services. Illustrative of these services are the public milk stations and the bath houses of London and other large cities, housing projects undertaken in connection with schemes for clearing improperly built areas, and the operation under certain circumstances of docks, wharves and ferries. Some social welfare projects should not be classed as public industries, but in many ways they present similar problems of policy and principle.

Revenue. A sixth motive is the financial one, the desire to obtain revenue for general purposes from the profit of publicly owned business enterprises. The fiscal monopolies of salt, tobacco, and matches are illustrative. Some cities use the net profits of their local utilities to reduce general taxation. The craze for internal improvements during the first third of the nineteenth century was inspired, in part, by the belief that the huge profits from state banking and other projects would render taxation unnecessary.

There are many other motives for public ownership. Their number and variety indicate how complex are the influences which determine the course of political action. Since the financial motive, that is, the desire to obtain a net revenue for public purposes, has been but one of many, and in some cases of less importance than others, the judgment of publicly owned industries solely on the basis of their financial showing would be in one respect improper, for there has been neither the intention nor the effort to earn a profit by their management.

From another point of view, however, it is entirely proper to consider the financial results of these undertakings. This is the effect that a given financial policy regarding the publicly owned enterprises may have on the taxes which must be borne by other classes in the community. Deficits in commercial enterprises must be paid from some other source of revenue, and the adoption of a policy of serving the public welfare or of operating at a loss for any other reason in such enterprises at once raises the question of the distribution of the whole burden of governmental costs. This question can be more adequately appreciated, perhaps, after considering some other matters of policy that are involved in the selection of the industries to be publicly owned.

CHARACTERISTICS OF THE PUBLIC INDUSTRY

It may be granted at the outset that circumstances may arise to compel a state or a city to embark on a program of public ownership without regard to any underlying principles. Necessity knows no law. These cases will be rather exceptional, however, and aside from such emergency situations it is appropriate first to inquire whether all industries are equally well suited to public management. If not, what are the earmarks of those

undertakings which are best suited to this method of ownership and operation?

Earmarks of the public industry. This question was discussed incidentally by Adam Smith in his comments on the post office. He said of this form of enterprise: ²

It is perhaps the only mercantile project which has been successfully managed by, I believe, every sort of government. The capital to be advanced is not very considerable. There is no mystery in the business. The returns are not only certain, but immediate.

In this brief statement are suggested three characteristics which an industry should display if it is to be suitable for public management. These are (1) a small capital, (2) the simplicity of the operations, and (3) the certainty and immediacy of the returns. Very little has been added to these criteria in all of the discussion of the subject since Smith's time.³ Professor H. C. Adams undertook to outline the conditions which should be present in the event that governmental participation in industrial activity is decided upon for the purposes of securing greater revenue or for other reasons.⁴ Bastable places the matter largely on the ground of experience, and holds that in general this experience is likely to be unfavorable to the introduction of any large system of state-directed industries. Where special reasons justify the action of the public power, he adds, there is no ground for objection to its employment. He appends the caution, however, that the success which may attend public operation of certain industries is no argument in favor of extending its activity to other and dissimilar cases.⁵

Granting that there may be certain industries which, from the standpoint of the foregoing tests, are suitable for public ownership and operation, the question next arises as to how to determine which of these should be taken over by some governmental unit. No certain and positive answer can be returned to this question. The matter must be left to expediency, to the special circumstances in any given situation. The issue eventually becomes one between the collectivists and the individualists; between those who would have the field of state economic activity enlarged as completely and as rapidly as possible, and their opponents. It would be futile to become involved in the controversy between the socialists and their critics over this point, since there would be no end to the debate. The safest conclusion appears to be that expediency alone should determine the policy to be followed. Some of the factors that may

² A. Smith, *The Wealth of Nations*, Cannan edition (1904), Book V, Ch. II, p. 303.

³ The criteria suggested by Jevons in his well-known argument for the nationalization of the telegraph system of Great Britain follow in general the tests suggested by Smith. Cf. C. J. Bullock, *Selected Readings in Public Finance*, 2nd ed., pp. 115-128.

⁴ H. C. Adams, *Finance*, p. 268.

⁵ C. F. Bastable, *Public Finance*, p. 197.

aid in the decision as to the expediency of a given policy will be noted below.

The management policy. The next question is that of the management policy to be applied in the event that certain industries are taken over by the state. Various possibilities present themselves, and the choice will depend on the extent to which the government is motivated by strictly financial considerations or by certain broader, social purposes. The public industry may be managed with a view to providing a surplus for the general treasury; it may be managed with a view simply of covering the cost, or finally, it may be managed on a basis of service without regard to the cost. If the fiscal viewpoint is chosen, the purpose may be to make the surplus as large as possible, in which event the public monopoly is serving as a means of revenue collection; or the attempt may be made to secure simply a fair return on the capital invested. The two alternatives in most common use are the fiscal monopoly, and operation on a service basis, profits being (in the latter case) an incidental feature. Generally speaking, there is less to be said for the operation of the industry as a monopoly than for any other, since this policy so frequently involves important consequences of other sorts that may outweigh the purely financial advantages. The use of any fiscal monopoly is likely to mean an inequitable distribution of the cost of government in relation to the ability of different classes to bear this cost, and it may produce other serious results. For example, the revenue motive led, in the case of the German railroads, to a series of rather rigid distance tariffs which restricted commercial development, compelled an unwholesome congestion of population, and in other ways cramped the economic usefulness of the railways. The typical American policy in the operation of publicly owned enterprises has been to place the extension of the service first, and then to operate the plant on a cost basis in view of the service being given, if this be possible. If not, the deficits have to be made up out of general revenues.

When the movement toward public ownership first set in, near the close of the last century, there was little need to consider the strictly financial aspects of the program. It was limited in scope, at first, and there was an ample margin of public revenue available under the taxing power for the discharge of any deficits that might be incurred. The rapidly rising cost of government during the past generation has changed the situation, especially for the cities and other local units, which are often subject to strict limitation on their powers of taxation and debt creation. With the growth of expenditures for such purposes as education, highways, charities and recreation, it becomes increasingly important to examine carefully the character of the commercial enterprises that the cities undertake, and to look into their policies of management, financial return and maintenance of capital. While a comfortable margin of public

income existed that could be readily reached through taxation or borrowing for defraying the possible deficits of these undertakings, there was little occasion for concern. Municipal ownership was a novelty through which the humanitarian impulse of the age might find expression by providing goods or services for some classes of the community at prices that did not cover the whole cost of production.

With the expansion of the scope and the cost of the public activities that are being financed out of taxes or out of the proceeds of public loans, the burden on the taxpayers has increased and the margin of readily available income for covering deficits in public industries has diminished. There is good prospect for the continuance of these tendencies, and for a further shrinkage of the margin of available local revenues under tax and debt limitations now in operation or to be imposed as expenditures increase. This situation renders necessary a more careful scrutiny of the financial aspects of the economic enterprises to be assumed by municipalities. The situation with respect to the states is parallel, although not as extreme, since these units have neither so completely used up their taxation resources nor plunged so extensively into economic undertakings as have the cities.

No one would insist that the financial side of the matter is of greatest importance in every possible case, but it is clear that the financial factors cannot be neglected. It is not always easy to draw the line between those undertakings which may be said to be a part of the fundamental duties and functions of government, to be supplied gratuitously to all of the citizens, or for the common benefit; and those activities which are simply socially desirable, or which may properly be classed as industrial or commercial.⁶ The real problem is whether the activity in question is of such vital importance to the general well-being that it should be undertaken by the public and operated regardless of expense, or whether it may properly be undertaken, provided there is no additional cost to the taxpayers. That is, provided it can be made self-sustaining.

A concrete illustration may make the point clearer. Every city of any size has the problem of removing and disposing of garbage as a part of the general obligation to provide and enforce the conditions that will best promote the health of the whole community. Garbage disposal may be viewed as a public function of such importance that the city may undertake it at public cost, using such methods for the recovery of fats and other by-products as may be warranted by the volume of material to be handled, and meeting the deficit, if such be the result, out of the general tax levies. On the other hand, it may be viewed as an enterprise

⁶ Adams speaks of education as an industry, but he does not mean that the state should take the same attitude toward the provision of educational opportunities as it would toward the production of electrical current for general use. *Finance*, pp. 276, 277.

in the same category as the production of gas or electricity. In this case, the cost would be imposed directly upon those receiving garbage collection service by the levy of a charge sufficient, with the receipts from the sale of by-products, to make the department self-sustaining. Irrespective of the decision in this particular case, the greatest care should be taken in the system of public accounting and in the classification of expenditures and revenues, to devise a method that will indicate clearly the fiscal results of whatever policy is adopted. The people should be able to learn the exact financial outcome of such policy as is followed with regard to the various forms of public activity, for the facts may have an important bearing upon the determination of future policy.

This does not mean that every publicly operated economic project that does not pay its way must necessarily be disapproved. It does mean that if certain forms of economic activity are to be undertaken, and are to be conducted at a loss on account of their social importance, it becomes the more necessary to look carefully into the financial results of those economic undertakings which should be self-sustaining if they are to be publicly managed at all.

More than this, it is quite proper and even necessary that a rigorous scrutiny be applied to the subsidized economic undertakings, in order to determine, first of all, whether such services need to be supplied below cost by the municipality or other governmental unit, or whether the subsidy might not as well be paid to a private concern which would perform the same service. Again, it is important to ascertain whether the management of the service in question is as efficient as it can be made, since this vitally affects the amount of the public subsidy. The fact that a given kind of activity promotes the general welfare is no excuse for lax and inefficient administration, or for the neglect of sound business management. The tests to be applied to the non-productive economic activities may be different, but they should not be less rigorous than those applied to the reproductive industries. Leonard Darwin has suggested that municipal industry is simply the question, in another form, of whether the labor required to perform a certain service shall be employed directly by the city or shall be employed by private concerns. If the city cannot employ and manage this labor to achieve a given end as efficiently as private contractors can, it is always important to discover the reasons for such inability.

On the other hand, the enterprise may be one in which social welfare considerations are put first, which means that certain groups receive a benefit that is paid for, in part, by other groups. But as Darwin suggests, the criterion of "the general welfare" must be used with care and discretion. It is quite conceivable, for example, that a city would be justified in owning and operating at a loss such an enterprise as a bath house, a crematorium or a waterworks, while it would be impossible to justify a

deficit in the operation of a municipal street railway or an electric light and power plant.

Application of any of the tests that are here suggested is not an easy matter. So much of the discussion of the subject of public ownership has been the product of partisanship on one side or the other that it is of little value as the basis of an independent judgment. As is usual in highly controversial subjects, there is great inaccuracy in the use of facts, and not infrequently exactly opposed conclusions are obtained from the same facts.

BUSINESS METHODS AND STANDARDS OF THE PUBLICLY OWNED INDUSTRY

It would appear to be unnecessary to refer to the business methods and standards of the publicly owned industry, for the natural inference is that the policies of management would conform as closely as possible to the most efficient techniques available. For various reasons, however, this is not always the case. The public industry lacks the two incentives to efficient management which are ordinarily operative in private industry. These are: first, the obligation to conserve the capital resources; and second, the pressure to show a profit from operations.

Public management is not motivated strongly by the profit urge, even when the enterprise is being operated deliberately at a level of rates which assures a net return. While the realization of net profits that are applied to general tax reduction is an objective, the driving force of general public opinion to secure this end is much weaker than that which emanates from the stockholders and impinges upon the management of a private enterprise.

The sense of obligation to conserve capital assets is likely to be dulled, for public management, by the fact that the body of taxpayers can be drawn upon to supply new capital assets with far less risk of serious complaint than would be aroused by private management if stockholders were to be assessed to replace assets.

Therefore, unless there is maintained in public management an extraordinarily keen sense of trusteeship, the business methods used and applied are likely to slump. The diminished incentive begets indifference. It is not necessary that the industry be operated with a definite view to earning a profit in order to require that it meet the strict standards which the profit motive would impose. Operation at cost or on the service principle without regard to cost also demands high standards of business efficiency.

The indifference to the conservation of capital assets often comes out in inadequate maintenance, or in deficient charges against income on account of depreciation. The experience of the Panama Canal administra-

tion, mentioned in the next chapter, is a conspicuous illustration of governmental indifference to the wastage of assets. In other cases the desire to show a profit, or to avoid a loss, or to keep down the amount of the current deficit, frequently inspires comparative neglect of these factors. The price of the popular goodwill essential to political supremacy in a city which owns extensive commercial undertakings may be low rates or prices, a margin of profits, or some other goal that can only be achieved by departures from ordinary good business standards. This is shortsighted, to be sure, but it is not characteristic of political expediency to take a long range view.

Accounting. Public management accounting should be as rigorous in its standards as if the enterprise were using capital supplied by individuals to earn a profit for them. This is precisely what public management is doing, but the connection between the whole group of citizens and their capital, and the bond of responsibility between the public managers and their constituents, are much more tenuous and insubstantial than is the case in private corporate organization, notwithstanding the charges that may justifiably be made with regard to absentee ownership and the relative lack of responsibility on the part of private managers.

The Census Bureau regularly comments on the defective character of the statistics relating to publicly owned commercial enterprises. In 1931 the following language was used: ⁷

The statistics of municipally operated public-service enterprises are for most cities defective because of the fact that their accounts are not completely segregated, and the enterprises are not credited with all the revenues arising from their activities nor debited with all the payments chargeable to them. For example, they may not be credited with the interest earned on their funds on current deposit nor charged with the interest on their bonds. And in many cases they are not credited for utilities furnished or services rendered by them to the various departments and to other public-utility enterprises of the city.

The main reason for this situation is in the slack accounting methods used, which fail to set up proper entries of debit and credit and carry them through the appropriate accounts. Back of this is the attitude that such charges and credits are of no consequence since it is all in the family, so to speak.

They are important, however, if the administration and the citizens are to know the exact results of their management. Accuracy in this matter may not make subsidies unnecessary, but it is never good policy to conceal such facts. If the utility is subsidizing the city by supplying services gratis, or if the city is subsidizing the utility by failure to charge for services to it, the true results of public operation can never be known. An alleged profit may actually be a loss, or vice versa.

⁷ United States Census Bureau, *Financial Statistics of Cities*, 1931, p. 45. Cf. also, *ibid.* 1933, p. 23.

The public industry as a "yardstick." The soundness of management policy and standards becomes especially significant if the publicly owned industry is to be held up in any way as a model or standard by which to measure the efficiency of private management. This idea has acquired prominence in connection with recent controversies over the rate-making practices of private companies, especially in the power field.

Insistence upon the establishment of a proper basis of comparison does not mean that a brief is held for either the rate-making or the capitalization practices of the private concerns in this or any other field. Any contribution that public management may make to the actual improvement in these practices will be more than welcome. No fair basis of judgment is possible, however, that does not rest upon reasonably comparable conditions. When comparisons of rates or profits are made without consideration of the factors that constitute advantage or disadvantage to one side or the other, there can be no sound decision between the merits of private and public enterprise.

There is strong temptation to omit certain important elements in these comparisons, and when this is done the "yardstick" idea is vitiated.

The taxation of municipal utilities. One element is the amount of taxes which the private concern must pay. When taxes are omitted, the public industry can charge lower rates than the private industry; but the inference from these rates, to the effect that public management is more efficient, is utterly unsound. It is contended that government does not tax itself, but this, of course, is not the point.⁸ Government does tax private industry, and in seeking to prove that public ownership is advantageous it must be shown that a given amount of capital, publicly owned and operated, can contribute as much toward general public expenses as it would if privately owned. Otherwise, the transfer from private to public ownership means a heavier tax on the remaining private property.

The tax comparison, when made, is usually limited to taxes on the property and sometimes the franchise. It is ordinarily overlooked that stockholders pay income taxes, and that death taxes are also collected on the transfer of their estates.

One of the foremost advocates of municipal ownership, in a study posthumously published, reached this conclusion with respect to the taxation issue:⁹

Clearly it is better as a matter of responsible public operation, with the financial results accurately shown, for the utility to pay the regular state and local taxes and the cost of all services received, and in turn claim compensation for all public services rendered, than it is to let one hand wash the other in a loose general way. This is regardless of the financial basis and

⁸ Cf. *Annual Report of the Inland Waterways Corporation*, 1933, p. 17.

⁹ D. F. Wilcox, *The Administration of Municipally Owned Utilities* (1931), pp. 61, 62.

theory of rates. Even where the city wants to operate the utility for profit transferable to the general fund for the relief of taxes, or if it wants to draw upon taxation for a subsidy to maintain rates at a specific level, this does not justify accounting short-cuts.

The investment return. A second element that is almost always omitted in the yardstick comparison is the profit on the investment. The rates of private companies are necessarily adjusted with a view to providing, normally, a return to those who supplied the capital. Their rates could be lower if there were no necessity of providing an incentive for the continued flow of capital funds as required, and no obligation to distribute an investment return upon the funds already provided. Government is under no obligation to earn a profit, it is true; but its yardstick rates, established on a non-profit basis, are not a true comparison with private rates in which a profit return must be included.

The analogy between government and private industry is often used, by comparing the whole people with the stockholders and public officials with private managers. The question of charging for taxes and profits in public industry is said to be beside the point since the people are at once the stockholders and the consumers, hence it is immaterial whether they receive their advantage in one capacity or the other. The nature of the tax system whereby the capital funds are provided and operating deficits are covered may impair the comparison. If the rates do not provide at least as much toward general public purposes as would be obtained were the industry privately owned, the result is a subsidy to the people as consumers and an added burden on the people as taxpayers. In so far as the incidence of the benefits does not correspond with that of the burden, the failure of the analogy is obvious.

The question of the extent to which government may justifiably disregard the profit element arises in connection with enterprises for which the funds are supplied by the people at large, while the benefits are enjoyed chiefly by particular regions. Many reclamation projects and the Tennessee Valley experiment are in this category. It would not be unreasonable to establish charges for power and other services that would provide a moderate return on the investment that is being made by the whole people.

It is not sufficient to contend, as many do, that public ownership saves for all of the consumers that which private ownership must charge in order to pay taxes and dividends. Unless public industry contributes something toward the general costs of government, the transfer from private to public ownership is a losing game. It would be proper to include in these costs, not simply the public services financed by general taxation, but also the cost of the capital invested in the public industries. This will be done if the capital is provided by bonds, for debt service charges will be included in the rates, in theory if not in practice. If the

capital is provided by a government contribution or subscription, it is no less an investment by the whole people, on which they are entitled to some return as an offset against future taxation. A moderate rate of return on this investment would represent an adjustment against the diminution of the mass of privately owned, tax-paying property occasioned by the addition to the public capital.

If the yardstick idea is properly applied, it is reduced primarily to a question of superiority of management. Can government coordinate and direct labor and capital in a given enterprise more competently than private management? If so, then its charges for services may justifiably be lower; and to this extent, a proper level of rates can be established by which to pass judgment on the defects of private management.

The corporate device for public management. Despite the criticisms often urged against the corporation, government is discovering that the management of particular enterprises can be more efficiently conducted under the corporate form than under the ordinary departmental form. The chief source of advantage lies in the freedom of the corporation from bureaucratic and legislative routine and red tape. Its managers retain control and use of the funds, instead of covering receipts into the treasury and operating under appropriation acts. They are therefore relatively free to formulate and execute policies to further the objectives of the undertaking. There is ordinarily much less of legislative interference and control, aside from the budgetary freedom that obtains. The two methods and their results are well illustrated in the case of the Panama Canal, operated as a governmental division, and the Panama Railroad Company, operated as a corporation.¹⁰

The corporate device may safely and properly be used in those activities which are essentially self-supporting, and in these cases it might facilitate the introduction of better business methods.¹¹ It would be a serious blow to popular control over finances if governmental departments supported primarily by taxation were to be organized as corporations, and thus removed in large degree from executive and legislative control over funds and policies.

The limits to public industry. The extent to which government can properly and safely go in acquiring and operating industries that may be deemed "ripe" for public management depends on the efficiency of public operation and on the rate policies applied. A certain amount of such operation can be undertaken, even if the rate policy or the inherent difficulties of operation are such that deficits ensue, because of the relatively large mass of private property and productive capacity to be taxed

¹⁰ Discussed further below, pp. 187-189.

¹¹ But see below, pp. 190-194. The Inland Waterways Corporation, after a decade of operation, was found to be in need of thorough reorganization. The use of the corporation device is not a guarantee against administrative "dry-rot."

to cover the deficits. As the field of public industry is expanded, that of private industry tends to be correspondingly diminished. Should such expansion occur, government will be under increasing obligation to operate the public industries on a bona fide self-supporting basis, since it will be more difficult to provide enough by taxation to cover operating deficits. Should public ownership grow steadily at the expense of private ownership, it will be necessary to go further, and strive for substantial margins of profit for general purposes, as the taxable base of private property dwindles.

CHAPTER XIII

The Industrial Domain: Federal and State Industries

THE PRECEDING chapter has dealt with some of the general aspects of public commercial and industrial undertakings, and it was there pointed out that the strictly financial aspect of the case has not always been controlling, either as to the motives or the policy of management. It is worth while, however, to examine some of the more important instances of public industry, with a view to the results of their operation. Government's operations in this field are becoming increasingly important. They involve policies that look far ahead, and concerning which there is none too much readily available information. Such criticism as may emerge is aimed primarily at the business methods used, rather than at the policy of public ownership as such. This chapter will deal, in the main, with federal and state industries.

COMMERCIAL ENTERPRISES OF THE FEDERAL GOVERNMENT

The public ownership movement has not, as yet, seriously involved the federal government, although the tendency is now somewhat in that direction. For a long time the post office was its only commercial undertaking. Then came a series of excursions into the field, for which there always seemed a sufficient case on the ground of need. These include the Alaska Railroad, the Panama Canal, the fleet of ships built during the war, the dam across the Tennessee River at Muscle Shoals, the inland waterway barge line, and, during the depression, loans, housing, power-plants and a miscellany of public improvements. Of these more recent manifestations, the invasion of the power field has been pressed most vigorously, but the motive has shifted from need of additional power facilities to an attack on the rates and profits of private power interests. Many of these activities have been too recently inaugurated to permit a judgment as to their policies or their prospects. This review of federal experience will be confined, therefore, to some instances in which the management policy and its fiscal results are fairly evident.

The post office. The postal system originated and developed as a means of transmitting written personal communications, and this aspect of its activity is now so general that it has become a recognized public

service. The authority to establish post offices and post roads was delegated to Congress, but the grant of power for this purpose has served to support great expansion of federal administrative powers along collateral lines.¹ The transmission of communications has never been regarded in this country as an essentially public function, for the telegraph and the telephone have remained in private ownership and the Railway Express Agency will carry merchandise or packages containing written matter.²

The modern post office has not confined its operations to the transmission of official and private communications; on the contrary, it has undertaken many services that are paralleled by private agencies. It has entered banking and will accept savings deposits, or it will transfer funds by means of postal money orders. It has acted as fiscal agent of the Treasury in promoting the sale of savings certificates and savings bonds. It has entered the field of the common carrier, and will transport and deliver merchandise, within certain limits of weight and bulk. The New Zealand post office, in addition to the above services, accepts registration of births and deaths and sells life insurance. During the war it was proposed that the post offices be utilized as employment exchanges.

In other words, the modern postal system has been expanded far beyond its original and primary function of transmitting intelligence. These accessory activities are essentially commercial in character, and may fairly be judged as such. In a broad view the whole may be regarded as a commercial enterprise, and in a narrow or strict construction those services other than the forwarding and delivery of first-class, or of first- and second-class mail, may be so considered.

Fiscal results of postal operation. A general historical view of the net results of postal operation is presented in Table I on p. 34. The treasury report for 1945 contains a tabulation of receipts, expenditures, surplus or deficit, and the amount paid into or out of the general fund from 1789 to 1945.³ Prior to 1836, the year in which the office of auditor for the postal department was established, there were small surpluses for the majority of the years. The aggregate net surplus through 1836 was \$2,022,479, of which \$1,092,160 was transferred into the Treasury. From 1837 to 1945 inclusive there has been a surplus of revenues over expenditures in seventeen years, and a deficit in each of the other ninety-two years.

It is well known that some branches of the postal service produce a surplus of receipts over cost, while other branches are handled at rates which involve an excess of costs. The data in Table XVII, for the fiscal

¹ Cf. W. W. Thompson, *Federal Centralization*, Ch. V. -

² The Postal Laws and Regulations were amended in 1932 to provide for a government monopoly of carrying letters and packets. The packet is defined as a packet of letters. Sections 1710-1715.

³ *Annual Report of the Secretary of the Treasury*, 1945, Table 13.

year 1944, illustrate the principal sources of the surplus and the deficit, respectively.

TABLE XVII

APPROXIMATE FINANCIAL RESULTS OF POSTAL OPERATIONS BY CLASSES OF MAIL
AND SPECIAL SERVICES, FISCAL YEAR 1944 *
(THOUSANDS OF DOLLARS)

<i>Classes of Mail Matter and Special Services</i>	<i>Excess of Revenues over Expenditures</i>	<i>Excess of Expendi- tures over Revenues</i>
Revenue producing:		
First class	\$170,494	
Air mail, domestic	29,531	
Air mail and other foreign	20,321	
Postal savings	12,719	
Unassignable	7,000	
Second class		\$100,730
Third class		25,090
Fourth class		14,463
Registry		1,733
Insurance		1,224
Collect on delivery		4,623
Special delivery		2,445
Money order		5,778
Total revenue producing:	\$240,065	\$156,086
Excess of revenues over expenditures (net)	83,979	
Non-revenue producing:		
Free in county (second class)		\$7,458
Penalty		30,805
Franked		829
Free for the blind		212
Registry		6,099
Total non-revenue producing		\$45,403
Non-postal services		\$808
Net excess of revenues, all operations	\$37,769	

* Source: *Annual Report of the Postmaster General, 1944*, p. 74

Some of the figures in this table are approximations only, based on data obtained in the periodic weighing of the mails and in other ways. Assuming that they are reasonably correct, they indicate that certain parts of the postal service contribute considerably more in revenue than the costs allocable to them while for other parts the reverse relationship prevails. There is a certain element of subsidy in some of the postal rate arrangements, but the degree to which it is a case of subsidy or simply a case of operation under joint cost, cannot be determined. The department leans, naturally, to the latter view. The cost ascertainment presented in the tabulations is said to omit such intangible elements as priority of service, preferential handling of letters and newspapers, and the relative value of the services to the patrons. It is contended, therefore, that these allocations of revenue and cost cannot be relied upon as a guide to the

proper postal rates. The keenness of the competition of other agencies is stressed, and also the fact that the present rates are, in some instances, all that the traffic will bear.⁴

The business methods of the post office. Governmental commercial enterprise must also be judged from the standpoint of the business practices and methods employed. These may affect the financial outcome, but they would not necessarily govern it, for no degree of business efficiency could ultimately prevail against an invincibly benevolent service policy. Yet it is important to know what the government's standards are.

Throughout its history the business methods of the Post Office Department have been on a low plane, although probably no worse, and not greatly different than those generally found in other departments.⁵ A joint commission surveyed and reported upon this subject in detail in 1908.⁶ The findings are too extensive to be presented in full but they constitute in the aggregate a serious indictment of the business methods then in use.

In some respects the situation has improved since this report was made, but its findings and recommendations have never been taken sufficiently seriously to lead to drastic reforms. There has been some decentralization in handling supplies requisitioned by postmasters. A uniform method of reporting cash receipts and disbursements by postmasters is at last in use, enabling the central executives to know promptly the results by states and appropriations for each month and quarter of the fiscal year as it progresses. Improvement may be noted also in the type of post office architecture. The joint commission had severely criticised the building and rental policies, notably the failure to provide facilities as the business expanded, the payment of exorbitant rentals, and the tendency to include quarters for the post office along with other federal agencies in a structure of massive proportions and imposing architecture. For postal purposes, loading platforms are more appropriate than a Greek façade. The newer buildings are more sensibly designed for the utilitarian purposes of the postal service.

On the other hand, the accounting system and the organization of the central offices of the department have not been greatly improved since the joint commission made its report. Postmasters still keep stamp sales, money order transactions and postal savings in separate funds and do more or less juggling among these funds in reporting. There is always more or less shortage in their accounts. The usual bureaucratic resistance to improved methods is operative and has prevented the general introduc-

⁴ *Annual Report of the Postmaster General*, 1930, pp. 50, 54.

⁵ Cf. W. E. Rich, *History of the Post Office to 1829* (1924).

⁶ United States Joint Commission on the Business Methods of the Post Office Department and the Postal Service, *Preliminary Report*, February, 1908, 60th Congress, 1st Session, Senate Report 201; *Final Report*, December, 1908, 60th Congress, 2nd Session, Senate Report 201.

tion of loose-leaf accounting and machine posting. The statement of assets continues to carry amounts known to have been abstracted by certain southern postmasters at the outbreak of the Civil War.⁷

The Panama Canal. The Panama Canal presents a mixture of commercial and non-commercial motives and methods. The canal was constructed to serve great national objectives, such as defense, increased mobility of the fleet in guarding the insular interests that had recently been acquired in both oceans, the promotion of coastwise and international trade, and the modification of overland transportation rates through water competition. As a great international public utility, it performs a service of immense value to world shipping. It was not built primarily as a commercial undertaking, and its justification does not require that sufficient revenue be earned from tolls to meet all costs, although this standard has almost been achieved, and could quite easily be maintained, as is indicated later.

While the transportation function performed by the canal itself is the primary and essential activity, this service requires the operation of numerous other enterprises, some of which, such as repairs to vessels and provision of fuel, are incident to the transportation service, and some of which are simply the services required by the residents of the Canal Zone, who are, for the most part, either in the military or the civilian service of the United States.

A dual administrative organization has been established, consisting of the canal administration and the Panama Railroad Company, a corporation organized shortly after the California gold rush began, and now owned by the federal government. Some of the services administered by the railroad antedate the acquisition of the Canal Zone, but the present distribution of service responsibilities between the two authorities is more or less a result of the developments during the decade of construction, 1904-1914, and the subsequent period of operation. The canal administration is also responsible for civil government in the Canal Zone.

The essential point of contrast between the two agencies is that one is organized as a corporation and is therefore relatively free to handle its own funds, make its own decisions, and stand or fall by the financial results achieved. The other, namely the canal administration, is an adjunct of the federal government. All revenues collected are covered into the Treasury and all expenditures must be authorized by act of Congress. Its management, particularly of finance, is therefore hedged about by all the red tape and bureaucratic routine that characterize departmental operations in general. That the canal has been managed so well has been very largely due to the practice of selecting as governor an engineer who, prior to being appointed to the governorship, has spent four years as maintenance engineer. To date, these persons have also spent, in turn,

⁷ *Annual Report of the Postmaster General*, 1944, p. 130.

some three years as assistant maintenance engineer. Thus the successive executive heads of the organization have come to the post with thorough knowledge of the basic engineering aspects of canal operation and management. Since they have all been selected from the army engineering corps, they have already had thorough training, and usually a considerable practical experience, in other similar lines of work, on account of the river and harbor improvements for which the army engineers have been responsible.⁸

TABLE XVIII⁹

REVENUES, EXPENSES, AND COMPUTED SURPLUS (DEFICIT) OF THE CANAL AND ITS
AUXILIARY ENTERPRISES, 1914-1941
(THOUSANDS OF DOLLARS)

<i>Class</i>	<i>Amount</i>
Tolls	\$495,532
Civil revenue ..	5,804
Business profits	18,215
Total revenues	\$516,551
Net appropriation expenses *	235,453
Net revenues	\$218,098
Capital interest charge at 3% †	316,937
Computed surplus ‡	\$ 35,839

* After deducting canal earnings repaid to appropriations

† Interest prior to 1922 is included in capital investment.

‡ Deficit

Financial results of the Panama Canal. The overall results in round numbers for the twenty-one years during which the canal has been open to traffic are summarized in Table XVIII above.

Although the canal was opened to traffic in 1914, the construction period was not officially terminated until 1921, at which time a permanent basic capitalization was fixed. As of June 30, 1941, this account stood as follows, in round figures:¹⁰

TABLE XIX

ASSETS OF THE PANAMA CANAL, JUNE 30, 1941
(THOUSANDS OF DOLLARS)

Capital assets	\$588,158
Reimbursable expenditures; public works, Republic of Panama	924
Custodial funds	7,318
Working assets	34,073
Deferred charges	1,132
Total assets.....	\$631,605

⁸ For study of the general administrative aspects and problems of the Canal Zone, cf. M. E. Dimock, *Government-Operated Enterprises in the Panama Canal Zone*, 1934.

⁹ *Report of the Governor of the Panama Canal*, 1941, p. 113. For security reasons no reports were issued during the war.

¹⁰ *Report of the Governor of the Panama Canal*, 1941, p. 94

Two chief obstacles to the effective fiscal management of the canal are stressed by the governor in his annual reports. One of these is the failure of Congress to authorize adequate provision for maintenance and upkeep. In the report for 1934, the governor stated that approximately \$150,000,000 of the capital values were structures subject to deterioration and requiring regular repair and periodic replacement. These structures had then been in service for twenty years. He closed with the following significant paragraph: ¹¹

As a result of this limitation upon Canal fiscal policy, while it has been generally possible to maintain the self-supporting auxiliary plant structures in a satisfactory manner, the economies enforced upon the Canal during the last few years through failure to provide the replacement funds requested for other structures has created a condition of deferred maintenance which is poor economy and cannot be continued without threatening the efficiency of the Canal.

The second obstacle to the realization of complete fiscal self-support for the whole canal enterprise is the limitation on the rates of toll. The President is authorized to fix the rates of toll, subject to statutory limitations. Under an act passed in 1937, the toll for laden commercial ships could not be more than \$1.00, nor less than \$0.75, per vessel-ton. Ships in ballast may be charged a lower rate. The tolls now applicable are \$0.90 for laden ships and \$0.72, per ton, for ships in ballast.¹²

The act of 1937 provided for tonnage measurement according to canal rules, instead of according to United States registry rules, as had been the procedure since the opening of the canal. The trend of the registry rules has been toward reduction of the tonnage measurements, as a means of promoting the registration of ships under the American flag. The canal rules define a vessel-ton as one hundred cubic feet of actual earning capacity. Prior to the change made in 1937, some curious results were obtained by applying to foreign ships the tonnage measurement rules as formulated for American registry by the commissioner of navigation.¹³

Professor Dimock concludes, from his extensive survey of all aspects

¹¹ *Ibid.*, pp. 4, 5. This matter was again brought to the attention of Congress in the report for 1935 (p. 5) and in the report for 1941, p. 4. In the case of certain self-supporting activities, the revenues are authorized for re-expenditure by the governor, but only for maintenance of the plant producing the revenues.

¹² *Ibid.*, pp. 28-31. The governor has urged a rate of \$1.00 per ton, and \$0.60 per ton when in ballast, based on the canal rules.

¹³ The interesting case of the *Empress of Britain* is cited in the report for 1934, pp. 90, 91. Her net tonnage under Suez rules is 26,531 tons, and under Panama rules it is 27,503 tons. Under British registry it is computed to be 22,545 tons, but under the United States registry rules in effect at her latest transit of the canal prior to writing the 1934 report, her net tonnage was 15,193 tons, and the toll paid was \$10,500 less than that paid at the Suez Canal. By converting a small cloak room on an upper deck into an "apartment" (by removing the original equipment and installing a bed, chiffonier and portable washstand) exemption of 3,319 tons was obtained under United States rules.

of the organization and management problem, that the canal and the railway should be merged under one new corporation.¹⁴ The argument is obvious. It would free the canal from the long-range, rigid control now exercised by Congress, and permit its management to function with the directness and flexibility characteristic of the corporation. The advantages of this arrangement in purchasing, in maintenance, and in other matters of financial management are especially marked.

The Inland Waterways Corporation. The federal government has entered the field of the common carrier in a small way, by the operation of a barge line on the Mississippi and Warrior rivers. This commercial venture is a heritage of the first war period, when the barge system was established in an effort to relieve rail congestion. After the war it was discovered by various persons that huge sums had been expended on river and harbor improvements but that no corresponding extension of facilities for water-borne traffic had been forthcoming. This should occasion surprise only to those who might suppose that the main purpose of the "pork barrel" river and harbor appropriations had really been in all cases the improvement of rivers and harbors. Instead of abandoning the barge lines, it was decided to undertake a demonstration of the feasibility of water transportation, and thus to justify the large investment that had been made.

Until 1924 the project was managed as a division of the war department known as the Inland and Coastwise Waterways Service, but the usual limitations on a governmental bureau functioning as a business entity prevented the demonstration from achieving any notable results other than a steadily mounting deficit. In 1924 Congress created the Inland Waterways Corporation, subscribed to all of its stock and transferred to it all property and assets connected with the barge lines. The capitalization is as follows: capital stock, \$12,000,000, subscribed for by the Treasury; and paid-in capital \$10,363,000, which is the valuation as of 1924 of the property transferred to the corporation at that time by the War Department.

The change to the corporate form was undoubtedly an improvement, from the management standpoint, but this move to continue, on a more efficient basis, federal operation of a service so directly competitive with private agencies has stiffened both the opposition to and the defense of such action. The whole subject is highly controversial, as is inevitable with important vested interests at stake, and as usual, there is something to be said on each side.

The prospect of using the great river systems of the country for transportation purposes is very appealing, and the backward condition of the United States in this respect by contrast with other countries, is often emphasized. The relative adequacy and efficiency of other means of

¹⁴ Dimock, *op. cit.*, pp. 217 ff.

transportation are not always duly recognized, however. It is said that these natural trade routes should be utilized to provide cheap transportation, and that the facilities used on them should be integrated with rail and highway facilities to this end. The critics and opponents point out that water transport has not developed. The high tide of steamboat traffic was reached nearly a century ago, and the greater efficiency of the railroad has since demonstrated the uneconomic character of water transportation. The reply to this contention has been that the railways have always feared water competition, and have taken effective steps to throttle it by rate-cutting on the routes parallel to the rivers, by controlling the terminal facilities of the river cities, and by other devices calculated to hinder its development.

It would profit little to enter into this controversy, or to attempt a final judgment between the disputants. The discussion must be limited to a very brief account of the federal undertaking in the field of water transportation.

The design of Congress, as expressed in the act of 1924 and its later amendments, appears to have been the following:

1. To demonstrate by this experiment the practicability of inland water transportation as a field of private investment, and then, having proved this point.
2. To dispose of the investment on profitable terms.

The House committee which reported favorably on the bill to create the corporation in 1924 said, in its report: ¹⁵

The committee believes... that if this bill becomes a law, the Government can and will within the next five years demonstrate not only the practicability of water transportation but the great advantage and economy to shippers, and the profitable results that will reward private capital invested in transportation facilities on our rivers. *And when that time comes it is the judgment of the committee that the Government can dispose of its properties to private capital to an advantage and withdraw entirely from such activities.*

Another objective was that of providing a test of the feasibility and wisdom of further expenditure on rivers and harbors to improve navigation. It was assumed that the success or failure of the government experiment would indicate what might be expected under private initiative, and the committee advised that further efforts to improve navigation be discontinued if the experiment turned out badly.

The act was amended in 1928, and while the original purpose of looking toward ultimate profitable liquidation was again expressed, conditions were set which probably involved indefinite prolongation of the experiment. The amendment declared the policy of Congress to be the

¹⁵ Quoted in *House Report No 1985*, 72nd Congress, 2nd Session, p. 34. This report is entitled *Report of the Special Committee Appointed to Investigate Government Competition with Private Enterprise*. (Italics supplied.)

continuance of the transportation services of the corporation until there shall have been provided:

1. Navigable channels in the rivers where the corporation operates.
2. Terminal facilities adequate for reasonably regular and dependable services.
3. Such joint tariffs with rail carriers as shall make available joint rail and water transportation on terms reasonably fair to both rail and water carriers.
4. Privately owned common carrier service on such rivers.

The act provided further that when the conditions under (1) and (3) above had been met, the Secretary of War might, in his discretion, lease or sell to private concerns the equipment and facilities of the corporation. No lease or sale was to be made to a railway or to anyone connected with or interested in railways. There must also be a fair valuation of the property by the Interstate Commerce Commission, and any purchaser or lessee must give bond to guarantee continuance of the service.

Joint tariff arrangements have been established, although their fairness has been questioned by the railroads. The obligation to guarantee service would be sufficient to deter private investment, as the act contains nothing relative to a release in case the purchaser or lessee was bankrupted by the venture.

Results. The field of operation includes both profitable and unprofitable sections. The lower Mississippi division, between St. Louis and New Orleans, has been consistently profitable, owing to the natural density of available traffic; but all of the other divisions have been as consistently unprofitable. The original barge lines had included the Warrior River division, from New Orleans via Mobile to a point near Birmingham, Alabama. Neither the government nor the corporation has been unable to resist the pressure to make further unprofitable extensions, despite the adverse experience with the Warrior division. An upper Mississippi River division was created, from St. Louis to the Twin Cities; another route was opened on the Missouri River to Kansas City, and a fourth was established to Chicago via the Illinois River and the Chicago Canal.

This is a familiar experience under government ownership. It probably means indefinite postponement of the goal of liquidation set by the act of 1928. The upper Mississippi River provided originally only a four-foot channel, and this was deepened to nine feet at great expense. It would be unfair to charge to the barge line any part of the capital cost of keeping the lower Mississippi River within bounds, in view of all that must be done there to control and prevent floods. The huge expenditures elsewhere to provide navigable channels and river terminals are more directly connected with the water transportation experiment, and some

account may properly be taken of these capital expenditures in judging of the financial results.

The corporation's operating results and financial condition would not rate well by ordinary business standards. The budget for government corporations reports that operating losses prevailed from 1924 to 1930; operating profits were experienced in most years to 1938; since then operating losses have occurred. The earned surplus is said to have been in excess of \$2,500,000 in 1938. Part of this resulted from action of the Interstate Commerce Commission in 1932, authorizing the elimination of charge-offs in the case of donated property as it was used up and retired from service. This ruling transformed a deficit of \$276,421 as of December 31, 1931 into a corporate surplus of \$617,132 as of January 1, 1932.¹⁶ Subsequent losses reduced the 1938 surplus to \$106,548 in 1945. In 1947 the deficit is expected to be \$2,474,000.¹⁷

The budget message indicates that the corporation's real condition may be worse than the book figures reveal. Its physical assets are being depreciated, with Interstate Commerce Commission approval, on the basis of 33 $\frac{1}{3}$ -year life. The message comments as follows:¹⁸

This 3 per cent rate (i.e., of depreciation) has not been charged uniformly during the Corporation's existence, however, and as a result the Corporation's books do not show the full amount of depreciation that would have accrued at this rate. In addition there is a strong possibility that the proper service life of this type of equipment is not 33 $\frac{1}{3}$ years, but rather 30 years or even 25 years. If this is the case, the amount of underdepreciation will be still greater, and as a result the Corporation's property will be still further overvalued.

This illustrates one of the greatest weaknesses of all government accounting. The purpose of depreciation charges against earnings is to recover the dollars expended on the assets which produce the earnings. Private business must do this or fail and pass under the sheriff's hammer. Public business has no such compulsion, for the capital can always be restored by further levies upon the taxpayers. Moreover, the corporation has always enjoyed certain governmental perquisites which have prevented the deficit from being larger. For years the chairman and executive head held the rank of major general and his salary was paid by the War Department. No rent has been paid for an office maintained in Washington. The corporation has had the franking privilege on its mail, and the usual government discount on telegraph and telephone service. It has paid no taxes except on certain property and franchises in Alabama, nor

¹⁶ *Annual Report of the Inland Waterways Corporation, 1932*, pp. 5, 34.

¹⁷ *Corporation Supplement to the Budget for the Fiscal Year 1947*, pp. 349-363, presents the data relative to the Inland Waterways Corporation and its subsidiary, The Warrior River Terminal Company.

¹⁸ *Ibid.*, p. 351.

has it set up a tax charge for equalizing purposes in computing costs and so-called savings to shippers.

In the early years of the war the corporation sold part of its operating equipment to the Reconstruction Finance Corporation. This enabled it to buy some war bonds and as of June 30, 1945 it had \$6,600,000 of such investments, representing the proceeds of the equipment sale and some depreciation reserves. By June 30, 1947, \$4,600,000 of these securities will be sold. As the anticipated deficit shows, half of the proceeds will be used to cover the losses in operation. This is the way any business must cover its losses—by dipping into capital.

In 1935 the Secretary of War invited Professor M. E. Dimock to survey the corporation and its activities. He produced the amazing conclusion that the federal government should establish new corporations to take over the railroads and the principal trucking companies, with itself as the principal, if not the sole, stockholder. The basis for this conclusion was the belief that the Interstate Commerce Commission could never satisfactorily integrate the joint rate tariffs for rail, water, and highway transportation.¹⁹ That is, in order to salvage a \$20 million investment in water transportation, the federal government should take possession of private rail and highway transportation properties worth some \$25 billion. This would indeed be burning the barn to kill the rats.

Oddly enough, Professor Dimock believed that the management of the corporation, after only ten years, was in need of thorough shaking down. It needed to reduce the overhead, to provide an active board of directors, and to inaugurate various improvements designed to secure greater efficiency and economy.²⁰ This criticism goes to the heart of government operations, commercial and otherwise. The public assets, whether property or money, belong to every one and hence to no one. They come from a well that is as inexhaustible as taxable capacity or borrowing capacity. Public censure of mismanagement, so long as it occurs within the law, is slow and uncertain, as against the sharp and sure condemnation by private groups of those who waste or mismanage the capital committed to them.

The Tennessee Valley Authority. Like the Inland Waterways Corporation, the dam and power plant on the Tennessee River are a heritage of the frantic effort of the first World War. The fixation of nitrogen from the air had only recently been demonstrated to be technically and commercially feasible when the war occurred, and a super-power plant was planned to supply this essential war material. The war ended before any explosive was made with nitrogen from this plant, and the government found itself possessed of a huge hydro-electric property. For years

¹⁹ M. E. Dimock, *Developing America's Waterways: Administration of the Inland Waterways Corporation* (Chicago, 1935).

²⁰ *Ibid.*, p. 102 and Ch. V.

nothing was done, since Congress could not agree upon a policy, whether of sale, lease, abandonment, or development. After years of debate, an act was finally passed in 1933 which established the future policy as one of development.²¹

The act created a corporation named the "Tennessee Valley Authority." No provision was made for capital stock, but in order to finance future construction, the corporation was authorized to sell serial bonds on the credit of the United States, to an amount not exceeding \$50,000,000, maturing not later than fifty years, and bearing interest at not more than $3\frac{1}{2}$ per cent. It is managed by three directors, appointed by the President for regular terms of nine years. No person shall be appointed who does not profess a belief in the feasibility and wisdom of the act.

Extensive powers were conferred upon the corporation, and a comprehensive program has been laid out for the economic and social regeneration of the whole Tennessee Valley. The principal controversial issue has been that of the sale of power in competition with the private power companies operating in that region. In the early enthusiasm over the project much was said of the use of the power facilities as a yardstick by which to demonstrate the proper level of rates at which electrical energy should be sold. Since the test of a fair rate level for electricity involves, among other things, the investment in the plant used in its generation and a reasonable net return on this investment, it is interesting to note the provision made in the act for determining this point. Section 14 requires the board to investigate the present value of the dams and other equipment, for the purpose of ascertaining how much of the value and the cost of these properties shall be allocated and charged to "(1) flood control, (2) navigation, (3) fertilizer, (4) national defense, and (5) the development of power." When these findings are approved by the President, they shall be final and shall be used thereafter in all allocations of value for the purpose of keeping the book values of the several properties. A like allocation is to be made in the case of any plants or properties constructed or acquired in future.

No brief is held for the rate-making or capitalization practices of privately owned power companies in pointing out that this section imposes a serious obligation upon the directors of the corporation. If the allocation required is to be worth making, it must result in establishing a book value for the investment deemed to be required for the development of power. Should this book value then be used, in future, as the base upon which to calculate the costs of power generation, and hence, the level of fair power rates, it must include everything that a private power company would be obliged to consider in establishing its value for rate-making purposes. Since the equipment will serve, jointly, all of the

²¹ *Public No. 17*, 73rd Congress (H. R. 5081).

purposes mentioned in the act, it will probably be necessary to set up another base value for rate purposes than that which results from a distribution of the total investment among five separate, but to some extent overlapping, purposes. Otherwise, the board will almost certainly establish a power valuation base lower than any private company could establish, and hence lower rates than private capital could afford to charge.

The essential issue involved is not simply the relative operating efficiency of a given plant under public or private management. Any genuine superiority of this sort displayed by public management would be more than welcome. It is as important for the government as for a private company to maintain the property, to provide for maintenance and depreciation out of earnings, and, insofar as the proceeds of bonds have been invested in structures that must eventually be replaced, to amortize the bonds. In order that the government-owned plant be operated on a fairly competitive basis, the corporation should be required to pay to the government, for general use, an amount equal to the taxes that would be paid if the business were in private ownership, and also an amount approximating a reasonable return on capital invested, above that represented by the bonds to be issued. The original investment was made by the whole people. The specific benefits of the enterprise, particularly in its broader aspects, will accrue mainly to the region involved. There is no good reason for investing large sums derived from all federal taxpayers in a commercial project chiefly of regional advantage, without requiring that it pay some sort of dividend on the investment, so to speak, to the people at large.

The board has contended that the wholesale rates established have taken account of most of the factors mentioned above. It is proper to express doubt on this point. To June 30, 1945, the total reported cost of dams and hydro-electric plants, excluding interest on capital funds advanced by Congress, was \$624 million. To that date \$607 million had been allocated as required by law. The allocation was—\$311 million to power, \$145 million to navigation, and \$151 million to flood control.²²

Here is the crux of the controversy over TVA accounting methods. A private company must necessarily charge the whole cost of its dams and other installations against the single purpose of power production, and its rates must reflect this charge, including taxes, interest, depreciation, and all other costs. As the above figures show, only about half of the total cost actually incurred to make possible the generation of electric power has been allocated to power production. Rates for power, based on such an allocation, are in no sense a reasonable measure of the cost to a private concern which must include both interest and taxes in its costs. It is, in no

²² Cf. Huet Massue, *Factual Analysis of the Tennessee Valley Authority* (1946), p. 59.

real sense, a proper measure of the cost of TVA power production to the whole people.

As to taxes, the act creating the Authority provides (in section 13) that 5 per cent of the gross proceeds from the sale of power generated at any hydro-electric dam in Alabama or Tennessee shall be paid to the respective states, and that 2½ per cent of the gross proceeds from the sale of power generated at any dam to be constructed for flood control or other purposes than power generation shall be so paid. The tax is not computed on the power used by the Authority or by the federal government in making fertilizer or in executing other purposes of the act. In other words, the tax charge is in no sense treated as a component of cost, nor is it in any way a determinant of the wholesale price. It is a resultant, computed on the amount received from power sales at such prices as may be established. The volume of gross proceeds is determined by the wholesale rates, but in setting these rates there is no question of taxes on the property as a cost element.

It appears, however, that the board is setting for the distributing agencies with which it contracts for the use of power, particularly municipalities, a different standard than seems to have been established by Congress for the Tennessee Valley Authority itself. The contractor must agree to provide, from its gross revenues, for operating expenses, debt service on electric-system bonds, reserves for new construction or contingencies, payments in lieu of taxes at rates equivalent to the taxes levied on other, similar property, and a return on the equity of not more than 6 per cent per annum. Retail rates are to be reduced should the earnings be more than sufficient to cover the above requirements. Strictly segregated accounts are to be kept according to uniform methods prescribed by the Authority.²³

These are excellent standards for government commercial management, but in order to remove completely the subsidy element the Authority should apply to its own financial operations the requirements that it exacts from the retail distribution agencies to which it supplies power at wholesale.

The investment in the Tennessee Valley Authority. As of June 30, 1946, the balance sheet of the Authority showed total assets of \$757,-869,058, of which fixed assets less depreciation reserves were \$734,176,292. Congressional appropriations less repayments amounted to \$665,020,000 and the property transferred from the War Department was valued at \$39,153,000. The power program has been the only source of revenue and the total net income from the beginning of operations on June 16, 1933 to June 30, 1946 was \$73,894,574. The other features of the program, such as navigation improvement, flood control, fertilizer production, and so on, have been a source of net expense, the total of which for the entire

²³ *Ibid.*, 1935, pp. 27, 33.

period of operation to 1946 was \$79,087,901. On balance, the total losses of the non-income producing programs have exceeded the total net income of the power program. Since the great bulk of the investment has been made from appropriated funds there is no question of concern about showing a reasonable return thereon. On June 30, 1946 the funded debt of the Authority was \$58,773,000, and on \$56,500,000 of this amount, borrowed on bonds sold to the Treasury, the interest rate was limited by agreement to 1 per cent, although the coupon rates of these bonds were $1\frac{3}{4}$ per cent to $2\frac{1}{2}$ per cent. The average cost of borrowed funds to the Treasury was well above 2 per cent when the agreement was made.²⁴

Government corporations. The instances of federal participation in commercial and other business activities discussed here are illuminating and may be considered as typical. They are, however, only a drop in the bucket by comparison with the array of corporations and agencies which has been established since 1932. There had been use of the corporation device during the first World War, but those were rather promptly liquidated at its close. During the 1920's the federal land banks were created. In 1932 the Reconstruction Finance Corporation was formed to serve as a credit agency to assist banks, insurance, and railroad companies in the depression years. As the years passed many other corporations were formed, either directly by the Treasury or as affiliates of a corporation already in existence. In general, the charters were obtained in the easy-going states, where the standards for corporate organization were not too high.

The development of these corporations was largely outside the hands of Congress and subject to no accounting or financial control. Once supplied with funds through sale of stock to the Treasury, or through sale of bonds to the public, they were free to lend, buy and sell, and engage in a wide miscellany of business operations. The first move to throw light upon a dim subject was Senate Resolution 150, in 1939, which instructed the Secretary of the Treasury to compile and submit to Congress information regarding the operations, commitments, and finances of the various corporations then in existence. This report was never published.

Numerous other corporations were created during the second World War. The argument for their use was that the corporation can act more effectively in meeting an emergency than would be possible in the case of an ordinary government bureau or agency. Nevertheless, the uneasiness grew over the lack of accountability and the possibility that some of them were using funds and in other ways departing from the intent of Congress. Although the fragmentary data compiled in response to the Senate Resolution revealed the need of more complete information, no action was taken by Congress to remedy the deficiency until the end of 1945,

²⁴ *Government Corporation Supplement to the Budget for the Fiscal Year 1947*, p. 81.

when the Government Corporation Control Act was passed.²⁵ This act required the President to include budgets for all government-owned corporations as part of the annual budget. Compliance with this provision led to the transmission of such a supplement on May 2, 1946.

The government corporations included in the supplemental budget operate in five major areas:

1. Corporations engaged in aids to industry. This group includes the Reconstruction Finance Corporation and such of its subsidiaries as have not already been dissolved. During the war these operations involved primarily the construction and management of war plants, procurement of essential war materials, and war damage insurance.

2. Corporations engaged in aid to housing. These include the various corporations and agencies established to finance housing construction and insurance, including temporary provision for veterans and also a long-range housing program.

3. Corporations engaged in aid to agriculture. The budget message states that seven wholly owned corporations and two groups of mixed-ownership corporations are integral parts of the program of assistance to farmers. The largest of these are the Commodity Credit Corporation and the Intermediate Credit Banks.

4. Corporations engaged in aid to international relations and trade. These include the Export-Import Bank of Washington and the International Bank for Reconstruction and Development. It was noted that the financial program offered for these institutions is necessarily sketchy and incomplete, although in any case it will be large.

5. Corporations engaged in aids to regional development. The Tennessee Valley Authority is by far the largest of this group. Others are the Inland Waterways Corporation, the Panama Railroad Company, and some minor corporations.

From the mass of data supplied in this first compilation of the government corporation budget, three condensed tabulations have been made which present a compact, overall view of the consolidated or aggregate financial situation. The budget summary supplies comparative data for the fiscal years 1945, 1946, and 1947, those for the last two years being estimates. Although the estimates for 1947 are at this time less accurate than those for 1946, they are used in the tables presented here, because of the significance of indicating the current thinking about the future rôle of the government corporations.

The first exhibit in the series is in the form of a consolidated balance sheet statement of financial condition as of June 30, 1947. This is given in Table XX.

The most important thing revealed by Table XX is the complete disappearance of the capital. It has more than disappeared. There is a deficit

²⁵ *Public Law 248*, 79th Congress, December 6, 1945.

of \$3,702 million where the capital should be. The bonds, debentures and notes payable are held in part by the Treasury, which means that the funds advanced for their acquisition were provided by additional public borrowing.

TABLE XX

CONSOLIDATED STATEMENT OF FINANCIAL CONDITION OF GOVERNMENT-OWNED
CORPORATIONS AS OF JUNE 30, 1947
(MILLIONS OF DOLLARS)

<i>Assets</i>		<i>Liabilities</i>	
Loans receivable	\$5,985	Bonds, debentures and notes payable	\$15,834
Lands, structures, equipment	6,806	Accounts payable	465
Commodities, materials, supplies	1,280	Accrued liabilities	85
Cash	386	Trust and deposit liabilities	147
Appropriated funds	212	Deferred and undistributed credits	2,181
Investments	729	Other liabilities	400
Accounts and notes receivable	342	Reserve for post-war support of agriculture	500
Accrued assets	81	Total liabilities	\$19,612
Advances to contractors and agents	138	Capital paid in	\$6,103
Acquired security and collateral	34	Earned surplus (deficit)	9,806
Deferred charges and debits	37	Total capital or deficit	3,702
Other assets	89	Unexpended appropriation	209
Total assets	\$16,119 *	Total liabilities, capital and unexpended appropriation	\$16,119 *

* Totals do not add or subtract because of rounding.

The second exhibit of the series is a consolidated statement of income and expense of government-owned corporations for the fiscal year 1947. This is given in Table XXI.

This table provides that part of the explanation of the loss of capital which pertains to the fiscal year 1947. In that year combined expenses are expected to exceed aggregate income by \$4,023 million. The total cumulative deficit differs from the total deficit in surplus account as given in the preceding table. The difference of \$360 million consists of reserves in this amount for contingencies and insurance. The actual net loss in 1945 was \$1,608 million, and that estimated for 1946 was \$3,175 million.

Finally, there is presented a summary statement of the sources and application of funds. This is given in Table XXII.

These summary data present an amazing picture of the great financial empire which has been created. It is a picture that would never have been drawn for the American people except for the act which forced the compilation and revelation of these facts.

TABLE XXI

CONSOLIDATED STATEMENT OF INCOME AND EXPENSE OF GOVERNMENT-OWNED
CORPORATIONS, 1947
(MILLIONS OF DOLLARS)

<i>Income</i>		<i>Expense</i>	
Sales of commodities and supplies	\$2,929	Cost of commodities and supplies sold	\$3,289
Sales of services	49	Direct operating expense	159
Rents	276	Interest	153
Interest and dividends	180	Insurance losses and claims	89
Insurance premiums	38	Miscellaneous expenses	88
Miscellaneous	92	Administrative expenses	81
Total income	\$3,564	Contract termination expense	67
		Subsidies	1,857
		Re-utilization of housing transferred under veterans' housing program	413
		Losses and charge-offs	1,515
		Total expense	\$7,711
Net loss after adjustment of reserves			\$4,023
Total cumulative deficit to June 30, 1947 . . .			\$10,166

TABLE XXII

SOURCE AND APPLICATION OF FUNDS FOR THE OPERATIONS OF GOVERNMENT
CORPORATIONS FOR THE FISCAL YEAR 1947
(MILLIONS OF DOLLARS)

<i>Source</i>		<i>Application</i>	
Collections on loans	\$1,223	Make loans	\$4,411
Sale of commodities	2,961	Purchase commodities	3,023
Sales (trading and manufacture)	85	Cost of sales (trading, etc.)	76
Sale of fixed assets	587	Purchase and improvement of fixed assets	431
Sale of security on defaulted loans	6	Acquire security on loans	2
Sale of investments	82	Purchase investments	38
Borrowing from Treasury	7,169	Repay treasury and public loans	4,106
Operating income	391	Operating expense	525
By appropriations	1,230	Pay direct subsidies	1,817
Grants and contributions	12	Direct payments on agricultural exports	30
Total funds provided	\$14,746	Return funds and pay dividends to Treasury	122
		Claims, indemnities, etc.	99
		Increase working capital	67
		Total application of funds	\$14,746

The scope of operations and the complete dissipation of the paid-in capital shown in Table XX were in part a result of the use of some corporations as agencies to finance and operate war activities. The cumulative deficit of the Reconstruction Finance Corporation arising out of war activities was \$1,161 million in 1944. By 1947 it is estimated to be \$7,074 million. This increase reflects, among other things, the losses estimated to be incurred in the disposition of surplus war property.

But capital impairment has not been peculiar to those corporations which were directly engaged in war activities. The Commodity Credit Corporation, for example, has repeatedly exhausted its capital. The total capital impairment of this corporation from 1938 to 1947 is estimated at \$3,251 million, against which \$72 million was repaid, leaving net impairment of \$3,179 million. Since this corporation has been engaged primarily in subsidizing agriculture it is clear that losses rather than gains were intended. The deficits incurred by other corporations are, by comparison, small.

The immense scale on which the government corporations are expected to operate, even in 1947, is indicated by the volume of funds which they are to obtain and apply, shown in Table XXII. The war emergency provided some warrant for the receipt and application of large amounts, but this emergency has now ended. Yet it is expected that they will handle a total of nearly \$15 billion in a single year. This will be a turnover almost half as great as the entire federal budget. Referring to Table XXII, it will be seen that in the aggregate the government corporations will collect \$2.2 billion of loans and will make new loans of double that amount. In this total is an estimate of \$2 billion as the total of new loans by the Export-Import Bank. Their purchases and sales of commodities are to be of the magnitude of \$3 billion. They are to continue with manufacture and trade, with the acquisition as well as the sale of fixed assets, and above all, with the payment of huge subsidies. Their indebtedness to the Treasury will increase by \$3 billion. Just where and how the Treasury is to get the funds to be advanced to the corporations is not made clear. It is pointed out in the message accompanying the budget that the deficits and losses to date have already been absorbed in the public debt. Naturally, any future action to restore lost capital will require appropriations. Obviously the Treasury cannot supply new loan funds in the amount of \$3 billion without first obtaining this amount in additional taxes or by a corresponding increase in the government's own public debt.

The record indicates that the federal government, acting through these corporate agencies, has invaded the private economy along a wide front. The invasion was conducted in substantial degree in an irresponsible way, for some of the corporations were not subject to audit by the General Accounting Office, and some were not even required to make

reports to Congress.²⁶ Obviously, none of them has been required to conserve and safeguard the capital with which they began. Granting the need and advantage of the flexibility afforded by the corporate device in furthering the war effort, it is now a major question of policy as to whether or not such practices should be continued.

The degree of public supervision and control provided by the recent law is wise and long overdue, but the issue goes deeper. Fundamentally, it is the issue of maintaining and continuing the elements of subsidy that unavoidably inhere in all such activities. Even with respect to the lending, investing, and similar services on which it is possible to show some net return, government is competing with private investors. Moreover, this competition is on terms which the latter cannot meet because of taxes, regulation, and other factors. Since the government corporations pay no taxes and need earn no profit, indeed, are not even obliged to account for wasted capital, they can do business on much cheaper terms than private agencies. But these are the elements of hidden subsidy to those who do business with the government on specially favorable terms. With respect to the open and outright subsidies, which are expected to continue at an enormous level in 1947, there is every reason, in view of the inescapable post-war expenditures and taxes, to heed the advice of the Committee on Postwar Tax Policy, which was as follows: ²⁷

The transition period (from war to peace) should be one in which the entire program of federal grants and subsidies is reviewed. The objective should be the reconsideration of all commitments to such programs whose continuance would jeopardize the prospects of postwar budgetary balance. We have already expressed our belief (Chapter I) that, under the conditions of prosperity and well-being which are anticipated and which we hope to promote by this program, there will be little occasion for a continuance of many of the grants and aids that have developed.

The cost of the total net losses of the government corporations can be brought home to the individual taxpayers as follows. The anticipated net loss of all corporations in 1947 is expected to be about \$4 billion. This amount represents the difference between an initial rate of 20 per cent and one of 13 per cent on individual income. Each person can figure his own share of this cost by applying 7 per cent to his taxable income.

COMMERCIAL ENTERPRISES OF THE STATE GOVERNMENT

Until the repeal of the Eighteenth Amendment in 1933, the states, with one principal exception, had made no extensive ventures into the

²⁶ Cf. *Government Corporations: The No Man's Land of Federal Finance*, published by The Citizens' National Committee, Washington, 1943.

²⁷ The Committee on Postwar Tax Policy, *A Tax Program for a Solvent America*, New York, 1945, p. 208.

field of business and commercial enterprises. For the year 1932 the Census Bureau reported the total earnings of state public service enterprises to be \$10,179,000, and the total payments for operation and maintenance of these enterprises to be \$6,330,000. The activities then reported upon included a miscellaneous collection of undertakings, such as docks and wharves, canals, ferries, electric railways, mills and elevators, cement plants, publishing houses, warehouses, and irrigation projects. As the aggregates of receipts and operating expenses indicated, the state business enterprises of that time were of negligible importance, either from the net revenue standpoint or from that of an invasion into the fields ordinarily occupied by private business.

With the return of a legalized liquor business, a number of states dealt with the problem of its control by setting up state liquor monopolies. This form of commercial enterprise is today by far the most important, from every point of view, that the states have ever undertaken.

State liquor monopolies. As of 1943, 16 states were operating alcoholic beverage monopolies. These were confined to the sale of such beverages, which were purchased from the ordinary manufacturers or wholesale distributors. No state has undertaken to engage in the manufacture of any form of alcoholic beverage.

The decision to establish state monopoly of distribution was based primarily on a belief that in this way some of the social problems presented by the general freedom of consumption could be more effectively dealt with than under the license system which had been general in the pre-prohibition era and which was adopted by the other 32 states.

While the local preference as to the better method of dealing with the various problems arising out of alcoholic beverage use and consumption was controlling as to the choice of procedures, the fiscal results indicate that the monopoly states have had rather the better of it. In 1943 the comparative revenues from the two systems were as follows:

TABLE XXIII
STATE GENERAL REVENUES FROM ALCOHOLIC-BEVERAGE MONOPOLY SYSTEMS AND OTHER
ALCOHOLIC-BEVERAGE SOURCES, 1943^{*}
(THOUSANDS OF DOLLARS)

	<i>Contributions from Monopoly Systems</i>	<i>Selective Sales Taxes on Alcoholic Beverages</i>	<i>License Taxes on Alcoholic- Beverage Businesses</i>	<i>Totals</i>
16 states with monopoly systems	\$95,600	\$70,771	\$19,092	\$185,463
32 states without monopoly systems	—	209,140	35,468	244,608

^{*} Source United States Census Bureau, *State Alcoholic-Beverage Monopoly Finances in 1943*, State Finances, 1943, Vol. 2. Typical reports, October, 1944.

The monopoly states received more than 43 per cent of the total state revenues from alcoholic beverages in 1943, but they had less than one-third of the total civilian population. Moreover, the monopoly states had on hand a net investment of some \$60,000,000, representing the excess of assets over liabilities other than net worth and reserves. The Census Bureau, in the publication just cited, summarizes some of the characteristics of the state monopoly systems:

- They are highly profitable.
- They contribute heavily to state general revenue.
- They have little fixed plant or equipment.
- They have only a small number of employees and a small payroll, in relation to the gross volume of business.
- They deal almost exclusively on a cash basis.
- They have no long-term debt.

It appears from these characteristics that the state alcoholic-beverage monopoly conforms well to Adam Smith's principles concerning the type of business best adapted to public ownership and management. Whether this system provides a better solution for the entire problem of control in its social as well as its business aspects, no one knows. Only a thorough and detailed study of the situation in the two groups of states can provide an answer to these questions.

The North Dakota experiment. The one outstanding instance of large-scale enterprise at the state level is provided by North Dakota. While this experiment is now a matter of history, except for the debts that remain to be liquidated, it seems worth retaining here as an object lesson.

In 1919 North Dakota embarked on a program of state enterprise which embraced banking, flour milling, the promotion of home ownership and various other activities. The moving influences were the resentment within the state against outside interests in these fields, and the belief that state action was the only way by which the North Dakota farmer could realize a fair price for his product. A Non-Partisan League capitalized the unrest and, having carried the elections, proceeded to launch the program. The league's control was short-lived, but the enterprises that were established, and the debts that were incurred, remain. The incident is in process of being closed, and space can be given only to a brief résumé and statement of the present situation.

Three main business undertakings were started—a state bank, a flour mill and terminal elevator, and a home-building program. The flour mill was the central project, since the hold of the grain and milling interests at Duluth and the Twin Cities was to be broken by converting wheat into flour within the state. The mill and the farmers required financial support, hence the state bank, which was to free the people from outside financial control. The home-building project was evidently a concession to the city dwellers.

The North Dakota State Bank. The bank's major function was to be that of public depository. Funds were redeposited in local banks, the selection being heavily influenced by the attitude of the latter toward the league. Severe losses were suffered after the depression of 1920, and to September 30, 1927, the total net loss was \$1,493,000. Meantime the state had embarked on a farm loan program, which involved the issue of state bonds against farm mortgages. The bank handled the appraisals, took the mortgages and assigned them to the state treasurer as security for the bonds. This service was discontinued early in 1933, in view of the increasing federal activity in refinancing farm mortgages.

This assumption of the farm debt burden was probably necessary, in view of the highly speculative nature of tillage agriculture in a region so near the precipitation minimum for crops. As of December 31, 1933, the total amount of real estate bonds outstanding was \$39,061,000. On that date the state owned outright 510,951 acres which had been acquired through foreclosure, and had options or contracts covering 52,352 acres additional. Governor Olson made the following significant statement in his message to the legislature in 1935:

The experience of the Bank of North Dakota in collecting interest on farms loans clearly indicates that funds for interest must be obtained from some other source. In the past year \$1,000,000 was transferred from the motor vehicle registration fund. Unless another source of income is found for the real estate interest fund, it might be well to renew the law again, transferring a part of the motor vehicle registration fees.

The regular banking department continues to serve chiefly as a public depository. On December 31, 1933, individual time and current deposits totaled only \$1,140,847 out of total deposits of \$19,493,700. The statement for this date showed undivided profits of \$527,700, but among the assets were \$1,300,000 in loans to the farm loan and collection department, which was not a particularly good loan risk at the time.

The mill and elevator. The flour mill and elevator, at Grand Forks, was put in operation on October 23, 1922. A second unit was begun at Drake, but later abandoned. Governor Shafer said, in his message for 1929, that after diligent effort to sell the Drake property, the best bid received was only \$2,500, which was not accepted. The state issued \$3,000,000 in bonds to construct the mill and elevator plant, and \$1,500,000 to provide operating capital. The construction bonds are still outstanding, but \$1,000,000 of the operating capital bonds have been paid.

A huge deficit has been accumulated, and the state has been obliged to carry the interest, redeem the bonds as they matured, and pay also the operating deficits, from taxation. The viewpoint of the protagonists of this venture is that the mission of the state mill and elevator is to demonstrate the superior quality of the state's wheat for flour purposes, and to assist the farmers in realizing a better price for their product.

Viewed in this light, the undertaking may justify itself, whether the debt service charges are earned or not.

The home loan program. The project for aid to home builders demonstrates the dangers of an unwisely administered state aid scheme. The law was disregarded at the outset, and has since been unenforceable. On December 31, 1927, the aggregate loss to taxpayers was reported to be \$415,761. The way in which this loss was incurred in one case will serve to illustrate the manner in which the state was left holding the sack. The law limited the expenditure for a house to \$5,000, if aid were to be given, and provided that the owner should have paid 20 per cent of the cost before securing state aid. A certain house in the city of Underwood showed an estimated cost of \$8,200 and an actual cost of \$9,849. This was not exceptional, for the average cost of all houses built was \$8,729, and the average of twenty-three houses in Bismarck was \$9,294.²⁸ The payments on the above house to December 31, 1927, amounted to \$4,816, leaving a balance of \$5,033. The state brought suit for the balance due, and the jury rendered verdict for the defendant, making it necessary for the state to charge off the entire book balance.²⁹ Evidently the jury did not include many large taxpayers.

In the message of 1929, Governor Shafer said that the home-building association debt to the bank was about paid off through the home-building deficit tax that had been levied since 1923. The ultimate loss would be about \$400,000.

In 1943 the Census Bureau reported that North Dakota's gross state debt was \$24 million. Of this amount, \$19 million consisted of real estate bonds originally issued, under the rural credit system, to finance farm mortgages. A sinking fund of \$18 million had been accumulated against this debt. Again it is demonstrated that sliding down hill is swift, easy, and pleasant, but climbing up again is slow, painful, and difficult. During the year 1943, \$575,000 of mill and elevator bonds were retired, but this agency borrowed fresh funds on short-term loans in the amount of \$425,000.

An interesting, and significant, item from South Dakota is a story of the coal mine which that state bought in 1919 with a view to saving its citizens large amounts on fuel bills. Because of the political influences that were at work, no location in the state could be agreed upon and a coal mine was bought in North Dakota. The expenditure for land, structures and equipment amounted to \$195,000 before the plan was finally abandoned as an active project. Mining operations were discontinued in 1930, and the legislature ordered the property to be sold. After six years of unsuccessful effort, an offer of \$5,500 was accepted.³⁰

²⁸ North Dakota Industrial Commission, *Report*, 1922, p. 33.

²⁹ *Ibid*, 1927, p. 114.

³⁰ Special dispatch from Pierre, South Dakota to the *New York Times*, April 12, 1936.

STATE-OWNED COMMERCIAL ENTERPRISES IN OTHER COUNTRIES

The principal fields of economic enterprise into which foreign national governments have gone have been transportation and communication, and certain industrial and marketing activities operated on a monopoly basis. The post office is everywhere a government industry or function; a substantial proportion of the world's railway mileage outside of the United States is publicly owned, and the same is true in even greater degree of the telephone and telegraph services.

The reasons for governmental occupation of these divisions of the public utility field are many, including all that were suggested in the opening pages of the preceding chapter and others applicable in specific cases. It is ordinarily not possible to compare public and private management of any of these industries under the same economic and political conditions, since the two types of ownership and management seldom exist side by side. One railroad system in France is publicly owned, but the relations between the government and the privately owned railway network have been such that there can be no proper test of the relative efficiency of public and private management. In Canada the dominion government owns and operates a large railway mileage in competition with an equally extensive private system. Here also the situation has been complicated by diverse economic and political considerations. The entire Canadian railway problem has recently been examined and those interested in the details must be referred to this monograph.³¹

In general, it may be said that considerations other than financial appear to have dominated the management of these groups of economic undertakings. Prior to the first World War the German railways, especially in Prussia, produced a substantial net revenue for the general treasury. They were later nationalized and the income surplus appears to have become negligible. It is of small avail to attempt comparison between foreign public ownership and private ownership in this country, so far as these instrumentalities are concerned, on account of the wide differences that prevail. This much can be said. In view of the superior standards of public administration in England or Germany, as compared with the United States, the poor results achieved in operating the telegraph in England or the railways in Germany, under these relatively favorable administrative conditions, should provide a powerful inducement to proceed with extreme caution in any effort to nationalize transportation and communication facilities in this country.

Fiscal monopolies. Some nations have established public monopolies of the production and sale, within the country, of certain articles for which the consumer demand is relatively inelastic. Under such a demand condition, the price can be raised substantially without great diminution

³¹ L. T. Fournier, *Railway Nationalization in Canada* (1935).

in the amount sold. Hence there is excellent opportunity for sizeable monopoly net profits.

TABLE XXIV

YIELD OF FISCAL MONOPOLIES, COMPARED WITH TOTAL NATIONAL REVENUES,
IN CERTAIN COUNTRIES *

(000 OMITTED)

<i>Country and Year</i>		<i>Total National Revenue Excluding Local Taxes</i>	<i>Monopoly Revenue</i>	<i>Percentage, Monopoly Revenue to Total National Revenue</i>
Albania	1936	14,765 gold francs	3,610	24.4
Lithuania	1937	188,708 litas	35,082	18.6
Poland	1936	1,639,643 zlotys	640,870	38.4
Rumania	1936	17,903,118 lei	5,551,947	31.0
Spain	1936	3,825,200 pesetas	639,300	16.7
Yugoslavia	1937	7,190,618 dinars	1,919,192	26.7

* Compiled from data published in *Tax Systems of the World*, 8th ed., 1940, pp. 373 ff. Owing to the disruption of fiscal systems by the second World War, such data were not compiled in later editions of this compendium.

The principal articles thus monopolized are tobacco, salt, and alcohol, especially in its various potent beverage forms. Table XXIV presents the monopoly revenue of those countries in which it constituted the greatest relative proportion of the total revenue according to the most recent available data.

Tobacco is the most important revenue producer, in so far as details are given in the sources from which the above figures are obtained. This is not surprising to anyone who has had experience with the atrocities committed in the name of tobacco by the state monopolies. In Spain, however, the state lotteries yield more than the tobacco monopoly.

The huge profits from a fiscal monopoly obscure the essential criteria of good management, since a substantial gain is assured, however badly the enterprise may be run. It may receive various concessions, such as free office or building space, free telegraph and telephone service, favorable freight rates and the like. When the government operates all of these services, a strict accounting among them is rather unlikely.

From the standpoint of a reasonable and equitable revenue system, the fiscal monopoly is obviously quite objectionable. But it should be noted that this device is most likely to be found in those countries that are so deficient in wealth and taxable resources as to doom the mass of the population to severe taxation in one form or another. Under such circumstances the monopoly may be little or no worse than the alternative exactions would be, and it enables the tax-gatherer to assume a different, possibly a less irritating guise than is afforded him in his customary rôle.

The absolute advantage of the fiscal monopoly as a source of revenue is not easily determined. Some part of the profit may be due to governmental favoritism, concealed by slack inter-department accounting. On the other hand, the monopolized commodities would ordinarily be singled out, in any case, for substantial taxation if produced and sold by private enterprise. Against the monopoly profit must be set also the taxes that could be levied on the property, incomes and estates of private producers. When these elements are considered, it becomes evident that the monopoly profit is not all clear advantage. Some part of it, possibly a substantial part, could be secured from the same commodities and from the capital employed in their production, if private production and sale were permitted. No approximation is possible however, as to the relative fiscal advantage of the two methods.

CHAPTER XIV

The Industrial Domain: Municipal Enterprises

THE FIELD of municipal enterprise includes, as its chief part, those activities and services which Wilcox called the municipal utilities. He listed the following as of greatest importance: water supply; sewerage and drainage; street railways; gas; electric light and power; and the telephone.¹ All of these, he held, had certain characteristics in common, such as the use of the streets for permanent fixtures and equipment, marked importance for the convenience of life under urban conditions, an inherent tendency toward monopoly, and very general, if not universal use by persons living in the areas of service. A considerable variety of other services are also found in public ownership, and they are frequently held to be clothed with a "public interest," but they are not in the front rank of the municipal utilities.

THE EXTENT AND RESULTS OF MUNICIPAL OWNERSHIP

Detailed data relative to the extent and the financial results of municipal ownership are difficult to secure, except by the slow and laborious process of direct investigation. The Census Bureau supplies some general facts in its reports on the financial statistics of cities. Municipally owned light- and power-plants have been reported upon briefly in the quinquennial census of electrical industries, last issued in 1932. It will be necessary, therefore, to restrict this discussion in the main to rather general data and inferences.

Water supply. The most extensively municipalized of all forms of economic undertaking is the water supply. In his annual report for 1900 the commissioner of labor presented the following summary of the situation in the towns of 1,000 population and over:

Of the 1,539 private waterworks, 32 per cent were in places of less than 1,000 population according to the census of 1890, while about 25 per cent of the publicly owned plants were so located. The public waterworks enterprises in these smaller towns and villages were of an unimportant and inexpensive character, and were established largely for fire protection.

¹ D. F. Wilcox, *The Administration of Municipally Owned Utilities* (1931).

TABLE XXV
PUBLIC AND PRIVATE OWNERSHIP OF WATER SYSTEMS IN 1900 *

	<i>Private Waterworks</i>	<i>Public Waterworks</i>
Number in United States	1,539	1,787
Total investment	\$267,752,468	\$513,852,568
Value of product	25,665,699	45,506,130

* Source. United States Commissioner of Labor, *Fourteenth Annual Report*, 1900, pp. 12, 13.

Fifteen years later the following summary of the number of public and private water-supply systems then existing was published:

TABLE XXVI
OWNERSHIP OF WATER SYSTEMS IN THE UNITED STATES AND CANADA IN 1915 *

	<i>United States</i>	<i>Canada</i>
Number of town listed	4,872	313
Municipally owned	3,045	256
Privately owned	1,355	48
Mixed ownership	37	4
Supplied from another town	435	5

* Source McGraw's *Waterworks Directory*, last issued in 1915.

There were 310 cities of 30,000 population and over in 1931, and of this group 260 owned their water supply systems. Indianapolis is the only city of more than 300,000 that does not own the water supply system. In 1930 there were 806 municipally owned water systems as against 280 privately owned systems in cities and towns of 5,000 population and over.² No recent statistics are available to indicate the present character of the ownership of water supply in the smaller communities, but there is no reason for supposing that the earlier trend toward municipal ownership has been reversed.³

The aggregate receipts, expenditures for current purposes, apparent operating income, outstanding debt and capital outlays of the publicly owned waterworks systems in the cities of 30,000 population and over are shown for certain years since 1911 in Table XXVII.

This is not a satisfactory method of presenting comparative data, for the cities included vary in size from New York City down to those barely

² H. B. Dorau, *Materials for the Study of Public Utility Economics* (1930), p. 929.

³ R. E. McDonnell, *Water Works Systems in the United States*, p. 9, states that there are in all 10,789 places with water supply of which 7,853, or 72.8 per cent, are publicly owned.

within the 30,000 population class. The number of cities and the total population supplied with water have steadily increased during the three decades covered by the table.

TABLE XXVII

SUMMARY OF THE FINANCIAL OPERATIONS OF MUNICIPAL WATERWORKS IN CITIES
OF 30,000 POPULATION AND OVER *
(THOUSANDS OF DOLLARS)

<i>Year</i>	<i>Operating Revenue</i>	<i>Operating Expenditures</i>	<i>Apparent Operating Revenue</i>	<i>Outstanding Debt at End of Year</i>	<i>Capital Outlays during Year</i>
1911	\$67,774	\$27,750	\$40,024	\$451,543	\$71,132
1915	77,465	33,057	44,407	541,299	50,481
1919	95,304	46,582	48,721	599,512	43,280
1923	138,455	73,493	64,962	541,864	90,018
1927	177,537	86,770	90,767	781,254	112,385
1931	215,852	100,468	115,384	1,393,487	133,270
....
1943 †	665,280	363,851	301,429	3,312,636	.

* Source United States Census Bureau, *Financial Statistics of Cities*

† Includes cities of 25,000 population and over

The water business has grown more rapidly than the population, for the per capita revenues in 1911 were \$2.40, and in 1931 they were \$4.47. In the cities of 100,000 population and over, the per capita revenue for 1933 was \$4.07.

On the whole the current finances of municipal water supply appear to be in good shape. The average operating ratio advanced from 40.9 per cent in 1911 to 55.1 per cent in 1921, and then declined to 46 per cent in 1931. These changes reflect the influence of the varying price level on operating costs. The particular local problem of adequate water supply is more significant, however, than the general price level. Local conditions, especially of a political nature, probably cause wide variations in the rates charged for water. In consequence, the financial situation of any given municipal water supply system is a resultant of the local rates charged and the local costs of providing water. In 1933 New York City spent for operation only \$0.343 out of every dollar of revenue collected, while St. Louis spent \$0.66, and Pittsburgh spent \$0.619. In Washington the expense ratio was 61, and in Minneapolis it was 59, while in Atlanta it was 20, and in Dallas, Texas, it was 34.

The revenues and expenditures reported by the Census Bureau are subject to the qualifications as to accuracy that have already been noted. Some years ago a committee working with the finances of New York City reported that it was impossible to ascertain the true conditions of

the city's water finances from the records as then kept.⁴ The third column of Table XXVII is entitled, therefore, the apparent operating revenue; that is, the amount apparently to be regarded as the excess of receipts over operating expenses. This excess must not be regarded, however, as being all a clear profit. The interest charges on the outstanding debt must first be deducted, and assuming that this debt bore on the average no more than 4 per cent during these years, about half of this apparent net operating revenue was required to pay the annual interest charge. The sinking fund or amortization requirements must also be subtracted. The census reports do not present the data in such form as to make possible a segregation of either interest or sinking fund charges against the outstanding waterworks debt, but it is clear that these two items together will reduce decidedly this apparent surplus.

It is necessary also to make allowance for such reserves and reserve funds as may be carried by the waterworks departments. On this point no material is presented by the census reports, but with the outstanding debt mounting to its present level, there is without question a large actual investment in such properties, and the annual charge against income on account of depreciation and for the establishment of proper reserves would of necessity be considerable. It may be said, on the other hand, that for much of this property the actual rate of depreciation is low since it is subject to but little wear and tear. The reservoirs, if properly built, are of this character. But the mains rust out, dams and conduits will in time require renewal, and the pumping station equipment will depreciate as rapidly as the similar equipment in any other use.

The annual capital outlays were large at the beginning of this period. The decline during the war years was doubtless due in part to the governmental control of labor and materials, as well as to the sharply rising prices for such construction work. Throughout the period, however, there has been a sufficient volume of annual capital expenditure to produce a steady advance in the outstanding debt.

In view of these considerations, it appears unlikely that the waterworks systems of these American municipalities, taken as a whole, have been contributing very much to the relief of local tax rates. It has probably not been the general policy to regard them as a means of aiding the general government, but to adjust the level of charges so as to render them self-supporting. The steady increase of the outstanding waterworks debt raises the question whether these establishments are really sustaining themselves, but it must be remembered that there has been a rapid growth of population and territory to be served in most of these cities during this period, and that some part, perhaps a considerable part, of the additional outlay has been made in order to provide large supplies of water

⁴ H. H. Lehman, *The Finances and Financial Administration of New York City*, p. lviii (1928).

for an indefinite future period. The general opinion is certainly to the effect that the municipal water supply systems are adequately self-sustaining, and there is nothing in the figures published by the Census Bureau to refute this view.

Electric light and power. The electrical industry has developed since 1880. During this time there has been tremendous growth, and rapid changes in organization and technology. The production and transmission of electricity have been peculiarly adaptable to large-scale operations. Great economies in cost have been achieved as the integration of generation in large plants with transmission over wide areas has proceeded. Naturally the integrating process and the advantages accruing from it have been the portion of private rather than public ownership. No city has been in a position, financial or legal, to plan a state-wide or interstate power system in order to realize all of the gains that might flow from large-scale production of electricity.

By reason of these extraordinary developments within the industry municipal ownership has not been able to keep pace with private ownership, although the two branches began fifty years ago on something like equal terms. The Census Bureau has made periodic surveys of the electrical industry since 1902 and the comparative growth of publicly and privately owned plants may be seen in Table XXVIII, which is based on these surveys.

TABLE XXVIII

COMPARISON OF COMMERCIAL AND MUNICIPAL CENTRAL POWER STATIONS 1902-1932 *
(DOLLAR AMOUNTS IN MILLIONS)

	<i>Commercial</i>				<i>Municipal</i>			
	1902	1912	1922	1932	1902	1912	1922	1932
Number of stations	2,805	3,659	3,774	1,627	815	1,562	2,581	1,802
Value of equipment	\$482.7	\$2,098.0	\$4,229	\$12,124.8	\$22.0	\$77.1	\$236.0	\$539.6
Total revenue	78.7	279.1	1,072	1,854.1	6.9	23.2	85.0	122.5
Total expenses	50.7	217.6	860	1,097.1	4.7	16.9	67.0	80.1

* Source United States Census Bureau, *Census of Electrical Industries*, issued quinquennially; last issued for 1932.

The internal development of the industry affected both the private and the public establishments. The period of integration was preceded by a rapid increase of isolated power stations, and in this race the number of municipal stations was close behind the number of the private stations, although the relative volume of capital investment and revenues indicates that the municipal plants were much smaller, on the average, than the private plants. The growth in the number of municipal plants was due to

the entrance of many small communities into the public ownership field.

There have been some shifts back and forth between private and public ownership in individual cases. In general the decrease of commercial central power stations has been due to the growth of large central generating plants and the distribution of electrical current over wider areas.⁵ When these plants are united under common ownership or control, they are often tied together so that the power produced is, in a sense, pooled for the entire circuit. The decrease in the number of municipal plants indicates the net loss through sale or reversion to private ownership.

In both fields there has been a steady increase in the average size of plant. This is indicated not only by the obvious rise in the average investment per plant, but by the increase in average horsepower and in average quantity of current produced. To some extent the isolated municipal plant has been able to keep pace with the economies of the large-scale private units by introducing modern generating equipment and by increasing the horsepower of the prime movers. Yet there was a steady increase, to 1925, in the number of municipal plants that were generating no current. In 1900 only thirteen out of 728 municipal plants generated no current, but by 1925, when there were 2,903 such plants, there were 1,354 that produced no current.

The explanation for this shift is to be found in the lower cost of current produced by the integrated commercial plants and the obvious advantage, particularly for cities on or near great transmission lines, in buying current at wholesale for local distribution. Municipal ownership of electric light and power systems has been tending toward ownership of the intra-mural distribution equipment and the elimination of local generation in favor of purchase from private producers.

The improvement of the Diesel engine has enabled the isolated plant, whether privately or publicly owned, to ward off the pressure of the large integrated companies. Many small communities remote from transmission facilities are introducing this source of power. In 1932 the internal combustion engine was the principal kind of prime mover in municipal plants, while in the commercial plants this type was exceeded in number by both hydroturbines and steam. More kilowatt-hours are generated by the municipal than by the commercial internal combustion engines.

The financial results. Some data relative to the finances of municipally owned electric light, and power plants in the larger cities are derived from the census reports on the financial statistics of cities. This is done in Table XXIX.

⁵ H. B. Dorau, *The Changing Character and Extent of Municipal Ownership in the Electric Light and Power Industry* (1929); E. O. Malott, *Forces Affecting Municipally Owned Electric Plants in Wisconsin* (1930), P. J. Raver and M. R. Sumner, *Municipally Owned Electric Utilities in Nebraska* (1932).

TABLE XXIX

RECEIPTS, EXPENDITURES, APPARENT NET REVENUE, OUTSTANDING DEBTS AND CAPITAL
OUTLAYS OF MUNICIPALLY OWNED ELECTRIC LIGHT AND POWER PLANTS
FOR CERTAIN YEARS SINCE 1911 *
(THOUSANDS OF DOLLARS)

<i>Year</i>	<i>Receipts</i>	<i>Expenditures</i>	<i>Apparent Net Operating Revenue</i>	<i>Outstanding Debt</i>	<i>Capital Outlays</i>
1911	\$3,571	\$1,820	\$1,751	\$10,101	\$3,060
1915	5,185	2,719	2,466	20,852	4,171
1919	10,447	6,830	3,617	26,700	5,922
1923	25,520	16,757	8,763	68,207	13,241
1927	39,869	20,578	19,291	103,148	14,568
1931	49,737	24,860	24,877	126,408	16,277
....
1933	32,367	14,956	17,411	114,428	5,075

* The indebtedness reported for 1915 and 1919 included that for municipal gas plants. The figures for 1933 include only the cities of 100,000 population and over.

The Census Bureau data for 1943 are based on returns from 48 cities. They show total receipts of \$124,784,000, operating revenue deductions including depreciation, of \$73,849,000, and net operating revenue of \$50,935,000. The reported data do not clearly reveal the disposition of this net revenue. Three cities report provision for taxes totalling \$1,011,000, and twenty cities report contributions to general funds aggregating \$8,486,000. More than half of this total was supplied by the municipal light and power systems in Los Angeles, California and Jacksonville, Florida.

Gas. The gas industry is even more completely in the hands of private concerns than the electrical industry. In 1909 the Census Bureau reported 119 municipal gas plants, but by 1929 the number had declined to forty-two. Many of these were evidently in small communities. The Census Bureau discontinued separate tabulation of data relative to municipal gas supply systems after 1927. In that year nine cities reported receipts from this type of enterprise. Limited data were presented again in 1943. Eleven cities had combined revenues from gas plants of \$8,219,000, with operating deductions other than depreciation of \$4,921,100 and net operating revenue before depreciation of \$3,298,000.

The results of the Richmond gas plant are summarized herewith. The city has owned the plant since 1851. The report for 1934 does not contain a balance sheet, but the income summary indicates a satisfactory current condition. The operating income for 1934 was \$581,659. Interest and debt redemption required \$193,975, and \$17,488 was spent for new construction, leaving a revenue surplus of \$379,197. In computing net income the value of gas delivered to the city without charge was included, and the

services rendered by the department of finance in billing and collecting were charged against income. The profits from the gas plant greatly exceeded those from water and electricity, and the aggregate profit, used for general purposes, was said to be equal to the yield of 23½ cents per \$100 in the tax rate.⁶

By 1944 the net income had materially declined, because of higher fuel and labor costs. The results for 1944 are shown in Table XXX, which gives also the returns from the water and electric enterprises.

TABLE XXX
SUMMARY OF MUNICIPALLY OWNED UTILITIES IN RICHMOND, VIRGINIA,
FISCAL YEAR 1944 *
(THOUSANDS OF DOLLARS)

	<i>Gas</i>	<i>Water</i>	<i>Electric</i>
Total income	\$1,622	\$972	\$473
Operating expenses	1,027	458	223
Income before other charges	\$595	\$514	\$250
Other charges:			
Depreciation	150	127	37
Taxes	125	140	46
Interest	129	166	2
Total other charges	\$404	\$433	\$85
Net income	\$191	\$82	\$165

* Source: *Annual Report of the Department of Public Utilities*, City of Richmond, 1944, p. 23.

Total net income from the three enterprises in 1944 was \$436,629. The relative advantage of the gas division over the water division springs from larger total revenues for gas, which is evidently a matter of comparative rates, and from the heavier charges against the water utility for taxes and interest. Professor R. M. Haig, in a recent study of the financial problems of the city, suggested a revision of gas and water rates to provide an additional net revenue of \$500,000 annually from these sources.⁷

Street railways. The municipal street railway situation may be briefly summarized. The outlook for the street railway industry as a whole has been growing darker for some years. Public ownership has not checked the decline. In 1907 there were 1,307 such companies operating in the United States, but in 1932 the total had dropped to 706. In many cities may be seen the rebuilt pavement that marks the passing of a street railway. The net operating income of all companies dropped from \$224,136,000 in 1922 to \$83,080,000 in 1932. The average number of fare trips

⁶ City of Richmond, *Annual Report of the Department of Public Utilities*, 1934, pp. 39-41.

⁷ R. M. Haig, *Richmond's Financial Problems*, 1945, pp. 46-49.

per inhabitant of the urban population declined from 270 in 1922 to 131 in 1932, although the total urban population was increasing during this decade. The increased use of automobiles has cut into the revenues, diminished the value of the property and reduced the number of the employees. To some extent municipal transportation has shifted to the bus, but this adaptation has salvaged only a part of the traffic loss occasioned by the privately owned motor vehicle.

The census of 1932 reported municipal ownership in eighteen cities, large and small. Detroit had the largest system, which then embraced 461.53 miles. Seattle was second with 236.68 miles, and San Francisco ranked third with 83.62 miles. New York City was operating 64.29 miles. St. Petersburg, Florida had the only other system of any size. In some of these cities, notably New York, St. Louis and San Francisco, the municipal property was only a part of the entire street railway system. Ten of them, and two other small municipalities, were operating bus lines, the total round trip mileage being 842.5 miles.

In general, the municipal experience has paralleled the private electric railway experience, and for the same reasons. Detroit and Phoenix, Arizona, were the only cities in which the revenues in 1932 paid the operating costs and the bond interest. The aggregate income deficit after fixed charges was \$988,593. Income deficits were reported from bus operation in every city except Detroit.

The subway systems of New York, Boston and Philadelphia are publicly owned, but in New York a part of the system had been leased to private companies for operation. An agreement was reached during 1935 for purchase by the city of the leasehold interests and the operating property and equipment owned by the companies, in order to unify the entire subway rapid transit system. Under this agreement, the city was to pay a net price of \$416,861,000.⁸ Operation was vested in a "board of transit control," which leased the properties from the city for a term of seventy-five years and assured the management thereof. Approximately three-fourths of the bonds issued to meet the purchase price were obligations of this board, protected by mortgages on the leases and property.

The full story of this most expensive and complicated example of municipal rapid transit cannot be told here. The whole situation is unique—it differs so greatly from all other such undertakings in magnitude, and in the character of the financial and political factors involved that it lacks all basis of comparison with transit experience elsewhere, and it provides little by which to judge of other undertakings in the field.

The following summary of the transit deficit and its causes tells the story:⁹

⁸ The terms of the agreement were published in the *New York Times* of November 2, 1935.

⁹ *Moody's Manual of Investments: Governments and Municipals*, 1946, p. 774.

The subway deficit anticipated in the budget for the fiscal year ending June 30, 1946, amounted to about \$47,649,000.

The outstanding bonded indebtedness of all subway property as of June 30, 1945, was \$1,155,244,000; sinking fund reserve amounted to \$209,744,000, leaving a net unamortized debt of \$945,500,000. Gross earnings were about \$125,668,000 for fiscal year ended June 30, 1945; operating expenses were \$111,684,000; net income over operating cost \$13,984,000 available for debt service.

The amount needed to meet interest and sinking fund requirements during 1945 was \$56,732,000; \$15,368,000 of this amount was paid from earnings of 1945 and prior years, leaving balance of \$41,364,000 to be paid from tax funds. It is estimated that fixed charges during 1946 will be about \$56,947,000, of which \$9,000,000 is expected to be paid from earnings of 1946, \$298,000 from investments and \$47,649,000 from tax funds. In addition, the city is planning to spend after the war from \$75,000,000 to \$90,000,000 in necessary rehabilitation of power plants, extension of subway stations, new rolling stock and completion of existing lines.

In 1944 there was a loss of 1.62 cents for every passenger carried in the subways, in 1945 loss was 1.76; in 1946 estimated loss on every passenger will be 2.01 cents.

Some details of the results of municipal railway operation in Detroit, San Francisco, and Seattle are given here to indicate the results that are being achieved. In all of these instances the volume of traffic was greatly increased during the second World War, bringing larger revenues and an improvement of the financial position. The restrictions on the production of equipment for replacement forced public as well as private business to keep rolling stock, machinery, and other equipment in service for an abnormal period. Substantial replacement expenditures must be made in the early post-war years. These replacements will involve new financing on a large scale.

Detroit acquired the city street railway system as of May 15, 1922, under an arrangement whereby payment was to be completed by December 31, 1931. These terms were rather onerous, and to this burden was added the obligation to spend heavily for rehabilitation of the system. The balance sheet for December 31, 1935, carried total assets of \$76,243,000 in round figures, of which plant and equipment value was \$60,795,000. The long-term debt stood at \$39,892,000. In addition, \$13,788,000 of funded debt had been retired from earnings, and \$6,682,000 had been added to property from earnings. The sinking fund reserves amounted to \$7,361,000.

The gross income from operation, after deducting taxes as required by the city charter, was \$2,842,000 for the calendar year 1934 and \$3,605,000 for the year 1935. After interest and sinking fund charges, there was a deficit of \$263,575, for 1934, and a surplus of \$509,042 for 1935. The improvement for 1935 was due to a definite increase in traffic volume and some reduction of operating expenses. The operating ratio

for both rail and coach divisions dropped from 77.46 per cent in 1934 to 74.07 per cent in 1935.¹⁰

For 1943 there was a net income of \$798,000. This declined to \$645,010 in 1944 and in 1945 there was a net loss of \$193,526. Despite the rise of operating revenues during these war years, the advance of operating and other costs was sufficiently more rapid to convert the profit situation of 1943 into a loss situation by 1945. The Detroit municipal railway system pays city and county taxes, and a moderate amount of motor vehicle taxes to the state.¹¹

The San Francisco municipal railway began operation in 1912 after a decade of struggle to secure popular and judicial approval of the project. Until 1944 a portion of the surface lines were in private ownership and operation, and a five-cent fare was charged on the city-owned lines. In May, 1944, by referendum vote the people authorized the acquisition of the private lines at a price of \$7,500,000. A seven-cent fare with universal transfers is charged on the unified system.

A summary view of the financial results from the beginning to June 30, 1944, is presented in the Table XXXI:

TABLE XXXI
CUMULATIVE INCOME STATEMENT, MUNICIPAL RAILWAY OF SAN FRANCISCO,
DECEMBER 28, 1912—JUNE 30, 1944 *
(THOUSANDS OF DOLLARS)

		<i>Amount</i>	<i>Per Cent</i>
Total revenue		\$100,307	
Total operating expense		79,797	80.09
Profit from operations		20,510	
Deduct provision for accidents	\$2,808		
depreciation	9,273	12,081	12.13
Income from operations		8,429	
Non-operating income		1,105	
Gross income		9,534	
Deductions from gross income for interest on funded debt	4,513		
miscellaneous debits	154	4,667	4.68
Net income		\$4,867	4.89
Taxes that would have been paid if privately owned		4,771	

* Source *Report of the San Francisco Public Utilities Commission, 1944*, p. 258

This, on its face, is a good record. The plant is well-depreciated, probably a necessary condition in view of the long service and unusual

¹⁰ City of Detroit, *Financial Statement, Department of Street Railways, for the Year Ending December 31, 1935*.

¹¹ City of Detroit *Annual Report, Department of Street Railways, 1945*.

strain of the war years. The original purchase price was not excessive, as such prices go. But it should be noted that the cumulative net income for the period would have been \$96,000 if the taxes which are set up for purely informative and comparative purposes had actually been paid. The private lines did have to pay local, state, and federal taxes. It would not be surprising if this differential were the determining factor in the decision to sell out.

The construction of the bay bridges has given rise to pressure for a subway rapid transit system. The estimated cost of the initial undertaking has been put at \$52,700,000. It is to be coordinated with the surface system in the beginning, but is to be designed so as to change from street car to train operation when necessary. There will be an advantage in unified municipal operation, a condition which New York has so successfully avoided. It will probably not suffice, however, to save the general taxpayers from further obligations in carrying the system.¹²

Seattle entered the municipal railway field in a small way as early as 1914, and in 1918 the entire privately owned railway property was acquired for \$15,000,000, the contract calling for payment of \$833,000 annually on the principal, beginning in 1922. At the close of the fiscal year ending on December 31, 1934, the city owned 121.25 miles of electric railway, and 4.04 miles of cable car track.

The financial results have not been satisfactory. To the close of the year 1934 the cumulative deficit was \$3,613,500. In 1933 the operating expenses were 108.7 per cent of operating revenues, and in 1934 this ratio was 104.31. Since 1930 the payments on the purchase price bonds have been far below the schedule, and the city has been obliged to issue general lien railway bonds, and in addition, to finance the system's deficits. In 1934 the city's liabilities for interest and principal of its general railway debt amounted to \$953,200. Under the circumstances, there could be no question of a contribution from the railway toward general expenses by a tax charge. The root of the difficulty was an inflated original price, and to this has been added, in recent years, the loss of revenue under the competition of the motor vehicle.¹³

The Seattle transit system continued to lose money until 1939, and the cumulative deficit to August 25, 1939, was \$6,747,681. On that day a reorganization of management was put into effect, whereby the control passed from the mayor and council to a transportation commission selected on a non-political basis. The new management promptly instituted extensive improvements in equipment, management, and financing. The most effective commentary upon the wisdom of the change is to be found in the reversal of the earnings trend. The deficits disappeared, and as of December 31, 1944, the total carried to surplus after absorbing

¹² *Report of the San Francisco Public Utilities Commission, 1934-1935.*

¹³ *Annual Report of the Seattle Municipal Railway, 1934.*

the adjusted prior deficits was \$1,740,386. Meantime, \$4,700,000 of debt principal had also been retired.¹⁴ The prosperity of the system is to be attributed, in part, to the large volume of traffic carried during the war years, but the significance of the change whereby the management was removed from political control cannot be overestimated, for there is no assurance that the former system would have avoided deficits even in the best years.

GENERAL RESULTS AND CONCLUSIONS

Looking back over the field of public commercial enterprise that has been so hastily surveyed, certain general results and conclusions may be indicated.

First, the irregularities of accounting practice render accurate determination of the financial results difficult, if not impossible. There appears to be need everywhere of stricter business methods in establishing the relations between the commercial enterprise and the general government, particularly if there is any thought of using the public project as a yardstick to measure the rates or the costs of competing private enterprise, or if it is to be a source of net revenue.

Second, there are limits to the extent to which government may safely go in operating public industry on a welfare or service basis, regardless of cost. The philanthropic ideal may be served in limited degree, while there is still a large volume of private taxpaying capacity to carry the load. Every extension of governmental commercial activity, whether in the field of the so-called governmental utilities or elsewhere, demands more rigorous regard for all of the items of cost involved in the accumulation and conservation of capital.

Third, the issue between governmental and private operation of those enterprises which are useful but not indispensable aspects of the governmental process is, at bottom, one of comparative efficiency of organization and management technique. Ownership is often advocated because its alternative, regulation, has so frequently been badly done as to suggest the conclusion that it cannot be done otherwise. Unless there is a definite superiority in the public administrative technique, it is at best a choice of evils.

Fourth, the comparative results of public operation in different fields suggests the validity of Adam Smith's criteria. Water supply, the most generally successful of all public undertakings, conforms closely with his tests of the public industry—the returns are certain, the management problem is on the whole not complicated, and in most cases the capital investment is not excessive. Even when the amount of waterworks capital is large, its forms are relatively simple. The distribution of electric cur-

¹⁴ Seattle Transit System, *Annual Report*, 1944.

rent, the next most general and successful form of municipal ownership, also meets these requirements.

Fifth, an increasing disposition to ignore the plain facts and implications of a subsidy in aid of an enterprise is to be noted. The ordinary concept of self-support or self-liquidation appears to have been dropped overboard. With unbelievable naiveté the suggestion is often advanced that a subsidy may be necessary in order to make a project self-liquidating. An early example of this simplicity of soul, and the first to come to the attention of the present writer, is the following, by Rear Admiral C. J. People, during the hearings on the \$4,800 million blank check appropriation bill of 1935: "It is difficult to make a slum clearance project self-liquidating unless there has been some sort of subsidy granted in connection with the project."¹⁵

A report to the New York City Tunnel Authority by the manager of the Queens Midtown tunnel relative to the present and prospective deficits from the operation of that tunnel stated that the federal grant should have been larger than it was "to make the project self-liquidating."¹⁶

Finally, there appears to be small prospect for the ordinary city to arrive at the stage of complete support of all other governmental services from the profits of municipal utilities. The occasional instances in which this has been done are all small communities, with comparatively modest budgets for general services.

¹⁵ *Hearings before the Senate Committee on Appropriations*, 74th Congress, 1st Session, on H.J. Res. 1117, p. 7.

¹⁶ *The New York Times*, January 25, 1946.

CHAPTER XV

Administrative Revenues

THE REVENUES obtained by the various departments and agencies of public administration in the course of performing their respective functions or services constitute what are called, in this book, *the administrative revenues*. They cover a wide range. Some are made for services that are closely akin to the other commercial services. Illustrations are the rents of real property and the interest on investments of trust and other public funds. At the other end of the scale are receipts which have some, though not all, of the characteristics of a tax. The element of compulsory payment in special assessments and some licenses illustrates this case.

A unifying feature of the whole group of such receipts is the fact that they all appear as a result of some administrative or service activity of government. If the service were not performed, there would be no occasion for the charge or the revenue. In theory there is involved, in nearly all cases, a particular benefit or advantage to the individual to whom the service is rendered, and in theory, also, the amount charged is designed to cover the specific costs of performing the service or the specific benefit arising from it. In practice, the scale of charges has to some extent become formalized by custom and has not varied closely with differences in administrative cost.

THE PRINCIPAL FORMS OF ADMINISTRATIVE REVENUE

The most important forms of administrative revenue are the fine, the fee, the license, and the special assessment. These terms may be defined provisionally as follows:

The *fine* is a charge levied on the individual in the process of enforcing the laws, as a punishment for their infraction. It is levied with regard to the severity of the offense rather than with regard to the offender's ability to pay, although judges and other officials responsible for enforcing the law frequently have the option of remitting or suspending the fine, or of varying the actual amount imposed within limits indicated by the statute. Ordinarily, however, the exaction is to be gauged by the attendant circumstances rather than by the offender's ability to pay. This charge is, of course, an exception to the statement above regarding

the element of benefit or advantage, unless the state, like the parent, is deemed to apply punitive measures for the good of the person punished.

The *fee* is a charge made for a special service rendered to the individual by some governmental agency. The amount of the fee is supposed to be based upon the cost of the service rendered, or at least on the special cost involved in maintaining and operating the office or bureau by which the service is performed. No account is taken of the varying ability of different recipients to pay. In practice, many fees are arbitrarily adjusted without regard to the present cost of the service and their amounts are frequently matters of historical accident.

The *license* is a term of somewhat similar import, but with the idea of privilege or permission paramount. Fees and licenses overlap somewhat. There is no unanimity of definition or practice, and the same charge may be considered a fee in one jurisdiction, a license in another, and possibly a tax in a third. There is no clear dividing line between the fee and the license. An arbitrary distinction is that a fee is paid in those cases in which a service is actually rendered to the individual, the charge for which is based on the cost of giving this service; and that a license is paid in those instances in which the governmental authority is invoked simply to confer a permission or a privilege rather than to perform a service of a more tangible and definite sort. The Census Bureau confines the term *fee* to special services of a clerical nature, and uses the term *charges* (not to be confused with the license) for those cases in which there is definite or tangible service rendered. The amount of the fee is usually fixed by law in advance, while the charge is determined after the work or service rendered has been finished.

The license partakes of the character of the fee, and of the tax. That is, it may be based on the cost of maintaining or operating the department which exercises the necessary oversight and which issues the permits or privileges. In such case it would be characterized by Seligman and others as a license fee. It might, on the other hand, be based on the value of the privilege to the individual, in which case it would tend to become a license tax, or a special tax on certain privileges and permissions.

The *special assessment* was originally a charge levied for the purpose of making specific improvements to property. This continues to be its principal purpose, but the use of so-called "special assessments" to pay certain specific current expenses has modified somewhat the original conception. As a charge to cover the cost of public works which result in a specific improvement of property it must be determined by the cost of the improvement. Theoretically, the amount of the assessment must not be in excess of the value created by the improvement, but practically this limitation is not always observed.

In each of these forms of revenue except the fine, there is a combination of public purpose and private benefit. This combination characterizes

these administrative revenues and serves to distinguish them from the economic revenues, which lack the element of public purpose; and from taxes, which lack the element of private or individual benefit.

THE NATURE AND PURPOSES OF THE ADMINISTRATIVE REVENUES

The distinction between those services to individuals that each should pay for as he receives them and those that should be paid for by general taxation and supplied gratis to all, is not always easily and clearly made. Yet this is the distinction that is involved in deciding whether to provide any service, whether it be education or a hunting and fishing preserve, on one basis or the other. All services of government are for the benefit of the citizens. To what extent should the cost of these services be met by tax levies, and to what extent by specific charges to individuals?

Full consideration of this question must be deferred until some aspects of the theory of taxation have been presented. The growth of the general tax burden is compelling all governments to give more careful consideration to the nature of the services rendered to individuals and to examine the possibilities of broadening the scope of the charges for these services with a view to providing some relief from heavy taxation. Some further characteristics of the several types of administrative revenue that have been used, traditionally, to cover definite and specific administrative costs will be presented briefly in order to observe in how far they may be suitable for extension of this sort.

Fines. The nature and purpose of the fine are such that it can never be used directly for revenue purposes.¹ They are an incident of penal and regulative administration, and the laws which provide for a penalty in the way of a fine are not administered for the sake of the fines as such, but with a view to promoting the larger ends of peace, justice and security to persons and property. The fine is, or should be, purely incidental, and the judge or justice who imposes a fine is supposed to do so because of the value of such a burden in impressing the offender with the necessity of law observance, and as a warning to others. The receipts from such a source may be used, through the budget, to defray the costs of the court. It is entirely possible that a busy municipal justice who is called upon to administer traffic or other ordinances may produce a revenue in fines greatly in excess of his own salary and the other court costs. Such surplus is available for general uses, or for the maintenance of the other branches of the city's judicial system. Many cities which have found the

¹ An exception, although an improper one, is found in the case of the so-called "speed trap," which is sometimes deliberately installed as a means of financing local units and filling the pockets of the officials who operate it. Another exception, also improper, was the systematic fining of "bootleggers" during prohibition, for the sake of the revenue.

enforcement of such regulations a difficult matter have been compelled to impose heavy fines, and they have derived, temporarily at least, a considerable revenue therefrom. Yet the revenue aspect must be entirely incidental to the major task of law enforcement.

Fees. A large number of governmental agencies collect fees for a wide variety of services. Although nominally or theoretically a charge determined by the cost of performing a specific service, such as recording a transfer of real property or the issue of a passport, the amounts actually charged seldom have a definite relation to the cost, and can have none while the deficiencies of government cost accounting remain. They are, for the most part, therefore, highly conventionalized charges.

Some authorities would regard any surplus over the cost of administering the service as a tax. This is hardly a tenable position, if the view taken above of this form of administrative revenue is correct. The fact that the state charges more for rendering the service than it costs does not remove the most important distinction between the fee and the tax, which is that the latter is a levy for general purposes without taint of special advantage, while the former is justified by the fact that a special benefit is being conferred. It seems preferable to regard such a revenue simply as the result of the fact that the state has unrestricted control over certain administrative functions, and is taking advantage of this fact to produce a certain revenue for general purposes. The state has a monopoly of public administration, and if it elects to exercise this monopoly for the purpose of securing a surplus of revenue over cost, such surplus is still a product of the public administration, and not a tax.

There are some possibilities of broadening the scope of the fee system in order to localize more definitely some of the specific costs of certain governmental services. The specific police protection given to banks, payroll messengers and other business firms, the special fire protection given to certain districts, special educational courses designed particularly to develop earning power, are illustrative. Fees in such cases would be charged only for the special service element, and not for the general service element to which all citizens are entitled.

Some broadening of the fee basis, or its equivalent, has already appeared in the "service charges" that are being collected in some places. The cost of operating and maintaining a sewer system is being met by a sewer service charge, and the same practice may be encountered in the flat charges for testing and servicing water or electric meters. Garbage removal has also been put on a fee or service charge basis rather extensively. To offset deficiencies in tax revenue the City of Honolulu introduced in 1934 an educational fee of ten dollars for high school pupils.

Social aspects of the fee system. During its earlier history the fee system was productive of rather serious social and political evils. Many local officials were authorized to collect fees for different services, and

these collections were retained by the incumbents as compensation. Under such circumstances nothing was more natural and more inevitable than that these officials should exert themselves in every possible way to increase the volume of business passing through their offices. Sheriffs and other police officials were compensated on the basis of the number of persons lodged in the jails. Altogether, the system of compensating public officials by allowing them to pocket the fees collected produced excessive diligence in looking after the kinds of public business that were remunerative, and equal neglect in attending to any other kind. The fee system had a pernicious effect upon the entire system of local government, increasing the demoralization of local police courts, and causing a sort of sinister competition for the more lucrative public offices. The modern tendency has been to put these local officials on definite salaries, and to use such part of the collections as might be required to pay the expense of these offices, while any remainder would be carried over for the use of the general government. Ordinarily, a large excess in any department does not happen, since there is usually pressure for reduction of the charges whenever a regular surplus occurs.²

Licenses. A possible distinction, suggested above, between the fee and the license charge is in the fact that the fee implies simply a service, while the license implies primarily privilege or permission. The conferring of privilege or permission is, in one sense, a kind of service. In both cases the element of special benefit to the individual is prominent. From this distinction arises the chief point of difference, which is that the license is more likely to be used in connection with some form of regulative control than is the fee. In other words, the license is more definitely an expression of the police power than the fee. The permission to operate a pool and billiard hall, or to hunt and fish, or to conduct a pawn shop, involves payment of a license. All of these and the many other similar cases involve an element of possible supervision, regulation, and control which is absent in such transactions as recording a deed, securing a copy of a public record, or inaugurating a court proceeding.

There has been considerable difficulty in distinguishing between the license as a charge made incidental to an administrative function, usually that of supervision and regulation, and the license as a form of taxation. Some taxes are imposed under the guise of licenses or in the form of license taxes. The chief interest, however, is in the form rather than in the substance of the license. As an enforcement measure under retail sales taxes, for example, merchants may be required to go through the formality of obtaining a license to sell goods, which may be suspended if the

² The persistence of the fee system, especially in the counties, as a basis of remuneration for county officials, is noted in a recent Minnesota study. Its abolition or reform is recommended. Cf. A. M. Borak and G. C. Blakey, *Fees and Other Non-Tax Revenues of Minnesota Local Units*, 1935.

tax is not paid. The state is not really interested, in such cases, in licensing retail stores, and the license element is a subterfuge. The ease with which applicants for motor vehicle licenses may register false or temporary addresses or even alias names indicates that this charge, originally designed for regulatory purposes, has lost much of its effective regulative character and has become a kind of motor vehicle taxation.

As the revenue motive and purpose become more predominant, the regulative element tends to decline in importance. In such cases the charge becomes more nearly a true tax rather than a license, whatever it may be called. As long as the form of the license is retained, however, another characteristic of this charge is always present, whatever may be the motive for using it. This is that failure to pay renders further exercise of the privilege illegal. Such a result does not follow in the case of the fee. If, for any reason, the fee is not paid when a deed is recorded, the deed is not invalidated nor is the record rejected. The person who sells liquor or drives a motor vehicle on the highway, without paying the established charge, is violating the law.

In view of the retention of the formal aspect of the license in a considerable group of important taxes, it would be appropriate to discuss them here. Since this would involve anticipation of some of the general principles underlying the use of the taxing power, these measures are dealt with in a later chapter.

Special assessments. As the term is ordinarily used, the special assessment means a *charge on property, imposed by proper authority, usually in return for special benefits conferred upon such property by an improvement of a public character for the expense of making which the assessment is levied.* The concept of a special charge for a specific improvement to property is an old one, and may be traced through the legislation of medieval England and the American colonial period of the eighteenth century. Despite its antiquity this form of revenue has received little attention from writers on public finance, nor has it been until recently of marked fiscal importance. The connection is obvious.

The special assessment came into prominence in American municipal finance during the last half century or so as the principal means of paying for the vast volume of local improvements which the rapidly growing cities were obliged to construct. There were several reasons for its popularity.

In the first place, the special assessment was deemed to be a more equitable fiscal instrument for this purpose than general taxation, in so far as the construction of these improvements actually enhanced the value of the neighboring property. The cost of the improvement was thus imposed upon those who were to receive so direct and obvious an advantage from it.

A second reason for the extensive use of the special assessment was

the desire to escape tax and debt limitations. Special assessment levies are always excluded from general tax rate limitations, so that the expenditure could be made in this way after the levies for other purposes had reached the legal limit established. In like manner the bonds issued for financing a large improvement project are not ordinarily included within the bond limitations applicable to the general debt of the municipality. In some states these bonds are not legally an obligation of the municipality, although the latter is required to enforce payment.

Finally, the special assessment afforded a means of overcoming the problem of property exempt from general taxation, since this privilege, enjoyed by religious, educational and philanthropic institutions, does not extend to those charges that bring a corresponding increase in the value of the property improved.

Contrast between the special assessment and the tax. At some points the special assessment is similar to a tax but in other respects a careful distinction must be drawn between these forms of revenue. The principal points of similarity are as follows:

First, there is an element of public purpose in each. The improvement to be paid for by a special assessment must be one that will promote the public or general good, as well as that of the individual owners. It would be quite unjustifiable to levy a special assessment for the construction of an improvement which promoted only private advantage, and for which no general good could be established.

A second point of similarity is that both the assessment and the tax represent an exercise of the taxing power. As a method of raising funds, the special assessment antedates all of the state constitutions but these now authorize the legislatures of the respective states to make or provide for such levies.

A third point of resemblance is that both the assessment and the tax proper are compulsory upon the individuals affected. In taxation this compulsion is general, while it becomes operative in the case of the special assessment only in the event that the preliminary conditions have been met, one of which may be the approval of an established proportion of the property owners to be affected.

Finally, both of these levies require a formal assessment or determination of the amount due, and the levying body has in each case a lien on the property for the amount of the levy in the event of a failure or refusal to pay.

On the other hand, the special assessment is not to be regarded as a tax simply because of the above resemblances. There are important differences between a tax and the special assessment, the chief of which are the following:

First and foremost, taxes are imposed to provide general rather than special benefits. The services of government benefit all citizens, whether

or not they pay taxes, but those who pay taxes have no claim to special benefits in return. On the other hand, the special assessment is levied against landowners only, and the money so collected may not be used except to meet the cost of acquiring land for a public use, or for the construction of improvements, such as sidewalks, curbs, drains, or pavement. These improvements presumably, and often in fact, increase the value of the land which adjoins or is adjacent to them, and this presumption is expressed in the definition of a special assessment as a charge levied in return for special benefits conferred on the property subject to assessment. As is pointed out below, however, it is not necessary, in some states, to prove that a benefit is conferred in order to impose a special assessment. The reciprocal relation between benefit and assessment was no doubt present in the beginning, and the idea has been perpetuated in the formal definition; but in practice a different condition sometimes prevails, and the special assessment has become a means of financing local improvements without the necessity of establishing a degree of local benefit corresponding to the amount of the assessment.

Second, the assessment may be imposed without regard to the rules of uniformity and equality that must be observed in the imposition of taxes. If the assessment were a tax, these rules could not be disregarded. The principle of ability to pay is recognized in the application of certain taxes, while the special assessment is determined by the special benefit received from the improvement, without regard to the equitable distribution of the cost in relation to ability.

Third, the exemptions that are sanctioned in the case of various taxes are not applicable in the case of special assessments.

Special assessments for current expenses. The distinction between the expenditures for permanent improvements, designated as *outlays* and those for current purposes, called *expenses*, suggests the necessity of reconsidering the definition of the special assessment as a charge made to defray the expense of a specific improvement to property. The current expenses met by the special levies against property included such things as street cleaning and sprinkling, garbage and refuse collection and the removal of ice and snow. The practice of meeting current operating expenses by a series of assessments against property owners or the tenants of business premises, raises the question as to what constitutes an improvement to meet the cost of which a special assessment may be levied. This is a legal question, the answer to which varies in different jurisdictions. The Illinois, Missouri and Montana courts have held that such expenses confer no benefit on adjoining property, while the contrary view has been expressed by the courts in Minnesota.

Assessments under the police power. The lawyers have distinguished another type of assessment that might possibly be used to meet the cost of certain of these current operations. This is the assessment made to

cover the cost of a legal duty which the property owner was bound to perform but which he had neglected or refused to perform. The removal of ice and snow, the proper trimming of trees and shrubs, or sprinkling, might be regarded as a duty devolving upon the owner or occupier. If the person responsible does not perform this duty, the city may do it and charge the cost to him. It is apparent, however, that such a charge differs from the true special assessment for local improvements as the latter are here defined and described.

In the first place, both property owners and tenants evidently have various obligations toward the state and toward the public that must be recognized and discharged. The cost of these obligations may not always be paralleled by a corresponding benefit to the property, yet, they may not be avoided. If the owner does not perform them, the government may do so and levy the costs against the property.

Secondly, such burdens are imposed as an exercise of the police power rather than the taxation power. The removal of offensive refuse, the abatement of a nuisance, the protection of the public during construction or excavation work, are examples of the obligations which devolve upon the owner of property, and which the city or state may enforce, either against the owner or by a levy against the property in event of the owner's neglect or refusal to pay the cost.

Thirdly, the owner has an option to perform the work for himself. Ordinarily the owner of property does not have this option in the case of the local improvements for which special assessments are levied. The enterprise is usually of such character that it must be carried out as a unit, which means that each individual property owner must pay his share of the cost without opportunity of performing his share of the work.

Finally, in the levy here referred to, there is no necessity of apportioning the cost according to benefit, since there is not necessarily any element of local benefit involved. If a number of property owners are jointly involved, the cost, when met by the state or the city, must be equitably apportioned among these owners, but the rule of benefit does not apply.

Administration of the special assessment. The proper application of the special assessment in practice gives rise to two questions of major importance. The first is the determination of the proportion in which the whole cost of the improvement shall be divided between the property owners and the general public. This is a question of policy which is ordinarily settled by the legislature in framing its street improvement laws. The older theory of the special assessment, which was incorporated in the formal definition, was that the levy was made in return for a special benefit which the property derived from the improvement. According to this theory, no assessment could be made if it could be shown that no

benefit was in fact received, and the amount of the levy could not exceed the amount of the special benefit.

This conception of the special assessment is no longer adequate to explain the actual facts of special assessment procedure. A more accurate definition of the special assessment would be that it is a special levy against real property to defray the cost of constructing such local improvements as the public convenience or necessity may demand, regardless of whether or not the property assessed derives therefrom a benefit equal to that cost. Thus, the legislature, in its discretion, may compel the private landowners to pay, not merely the cost of the improvement abutting upon their own property, but also the cost of that part which abuts upon publicly owned land. To illustrate, the cost of paving a street intersection may be borne out of general funds, or it may be spread over the lots cornering on the intersection. The governmental units owning land, such as the city, the school district or the park district, may be required to provide their share of the cost of paving or other improvements in the streets upon which this land fronts, or the entire cost of such improvements may be laid upon the privately owned lands subject to assessment. If the improvement results in a benefit to the privately owned land, it must also benefit the publicly owned land. If the private landowners must bear the entire cost of such an improvement, while all property owners and taxpayers in the city, school district or other governmental unit receive the benefit accruing to the publicly owned land without contributing through a general appropriation to the cost of the operation that produced this benefit, the result is a singular distortion of the benefit principle.

The decay of the old benefit idea may be shown in another way. Special assessment laws usually provide that the property owners affected shall have the privilege of expressing approval or disapproval of the project. This afforded them an opportunity to express their opinion as to the probable benefit. If the owners of a majority of the frontage or of the area (according to the character of the project) disapproved, the proceedings were held up for a certain period, usually six months or a year. The property owners would naturally object unless the resulting benefit were clear and substantial, and their right to do so was proper under the doctrine that they were to pay the assessment in return for a special benefit to be produced by the improvement. But under some laws the city council may initiate the proceedings, and a four-fifths majority vote of the council is sufficient to overrule even the unanimous protest of the property owners. Whether they see a corresponding benefit, or any benefit at all to their property as a result of the improvement, they may be compelled to bear its cost if the council is sufficiently united in its approval of the project.

The benefit doctrine has been undermined, also, in recent years by

modern transportation developments. Before the era of automobiles, the residents on a street were probably the chief beneficiaries of a pavement on their street. Their residences or their places of business became more accessible. The element of local benefit was no doubt greater than the element of general benefit. This may still be the case with respect to paving in strictly residential sections, and with respect to certain other improvements everywhere, such as sewers. It can hardly be true today of the paving of main thoroughfares which are used to such an extent by the general motoring public that the general benefit transcends the local benefit. A main thoroughfare has lost much of its advantage as a residence street, and the care with which cities are now routing the through automobile traffic around the business sections indicates that an excess of such traffic is not good for a business street. It is said that Iowa and some other states that used the local assessment on farm lands to finance highways discovered that land values were depressed in consequence. In other words, the general benefit from the improvement was everything, the local benefit less than nothing, since the burden of the assessment and the large volume of tourist traffic, coupled with the careless habits and predatory inclination of some of these migrants, made farming under such conditions a less attractive undertaking, not adequately offset by the opportunities of vending gasoline, eggs, and soft drinks. Here and there may be found some recognition of these changes, so far as the cities are concerned, in the provision that state highway funds may be used in the construction and maintenance of streets designated as arterial roads or main thoroughfares. It is far from general, however, and the unpleasant transition from the smooth state highway to the broken city streets is a mute testimonial of the iniquity of the old rule of local benefits. State highway departments usually place signs to advise the motorist that state maintenance ends at the municipal corporation line, but this does not save his springs, nor does it absolve the state from its responsibility for a more accurate and equitable apportionment of local and general benefits in the construction and maintenance of the highway system.

In conclusion of the discussion to this point, it seems evident that the law and the procedure of special assessment are in need of clarification. The difficulty is that there is no clean-cut statement of the fundamental theory underlying the exercise of this power. The one thing that stands out is that it may be exercised in some jurisdictions without regard to the relation of benefit to cost. The legal right undoubtedly exists to establish a district and compel the landowners in that district to pay the cost of an improvement. But the increasing emphasis on the factors of public convenience and necessity to justify these improvements has not been accompanied by a corresponding attention to the question of the proper distribution of the cost between the landowners as a group on one side,

and the general public, in the interest and for the convenience of whom the construction is undertaken, on the other. The net result is that the landowners are often penalized and subjected to an excessive burden, for the payment of a share of the cost of local improvements which should have been borne by the public at large out of general revenues.

The second major question that arises in the use of the special assessment is a technical one: How shall the total amount to be levied against property be distributed among the several parcels of property liable to the assessment? Whatever the theory may be as to the proportion of the total cost to be collected from the property owners, as long as some part of this cost is so collected, the procedure for determining the share of each is important. Several methods of apportioning the assessment have been recognized.³

The first is the frontage rule, according to which the cost is spread over the property fronting on the improvement, in proportion to the number of front feet in each parcel or lot. This plan is inequitable as between the deep and the shallow lots, and it is unsatisfactory as applied to irregular lots. Moreover, it does not permit of a determination of benefits beyond the abutting property. A second rule is the apportionment according to the superficial area. This method is useful for certain kinds of improvements, such as storm sewers, although when used alone it may prove too inelastic. For other improvements such as the building of streets and sidewalks, it leads to an obvious discrimination against the deep lots.

A third method is to distribute the cost according to the assessed value of land in the district. This was made compulsory in a California law of 1925 for all projects executed under that law. The act permitted the district to be zoned, and if this were done, each zone was made responsible for a fixed proportion of the total cost, the proportion being determined according to the engineer's estimate of the relative benefit to the lands in each zone. Bonds were always issued, and a special annual tax was levied on the land in each zone, a tax sufficient to pay that zone's quota of interest and debt redemption for the year.

The only advantage which this method presented was realized fortuitously. If the engineer established his zone boundaries correctly, and if the county assessor achieved substantial accuracy in his land assessments over a number of years, the burden would be distributed approximately according to the benefits as shown by the increases in land value. If these contingencies failed the plan failed, and it could become the means of perpetuating an injustice, since zone boundaries could not be changed, and the burden might be spread out over a maximum of thirty years. The

³ National Municipal League, "Report of Committee on Special Assessments," *National Municipal Review*, Vol. XI, p. 43. Cf. also, A. R. Burnstan, *Special Assessment Procedure* (1929) Ch. VIII.

plan imposed a heavy strain on the engineer, in requiring that he forecast the course of land values in the different zones over so long a period and establish his boundaries to fit this trend. It also imposed a strain on the assessor in requiring him to achieve complete accuracy within the improvement district over the same period. In view of these drawbacks, and in view also of the enforced resort to borrowing to provide the funds, this plan of distribution according to the course of assessed land values had little to commend it.

A fourth method is to base the distribution of cost on the proximity to the improvement. According to this rule, the cost will be spread over the entire area on the basis of proximity to the improvement, the nearer land paying more in proportion to its superficial area than that more distant. Various rules have been devised to graduate the cost according to the degree of proximity. These rules must be flexible because the relation between physical nearness to the project and the degree of benefit will vary with different kinds of local improvements. Seattle, Washington, for example, distributed the cost of street paving according to a series of thirty-foot zones. Forty per cent was charged to the first zone, 25 per cent to the second, 20 per cent to the third, and 15 per cent to all property more than ninety feet distant, this zone extending to the central line between two parallel streets. The zone system is less accurate than that in use in some other places, according to which the distribution is made by means of more minutely graduated tables, similar to those used by some assessors in valuing lots of varying depths. In still other cities various combinations of frontage and area or proximity have been devised to spread the assessment cost.

Finally, the rule of apportionment according to benefits should be mentioned. As a technical rule of apportionment, this is not to be confused with the benefit theory which was once supposed to underlie the general doctrine of the special assessment. The benefit rule of apportioning the assessment means that the cost, whatever it may be, shall be distributed among the property owners according to the distribution of such benefits as may in fact result. The local benefit, whatever it may be, becomes a scale, a series of ratios, which would serve as well for the distribution of an aggregate cost any number of times greater than the aggregate benefit as it would in the distribution of a cost less than the benefit.

¶ As stated in the statutes, however, the rule of distribution according to benefits is vague, and its application usually involves consideration of proximity, area, value, frontage, or other elements that might possibly throw light on the question of relative benefits. Since this rule permits flexibility, its use may result, when intelligently applied, in a more equitable distribution of the burden among the property owners than any other single, rigid rule of apportionment.

Theoretical defects. It may seem paradoxical to say that the basic assumption underlying the special assessment is at once sound and unsound. It would perhaps be more accurate to say that it is sound but has been sadly overworked, thus leading to serious errors in planning and financing improvements. If and when government expenditure on improvements creates special property value increases, and this is what is really meant by benefits, then the theory is sound. Under such circumstances it is possible to levy and collect assessments to pay part, at least, of the improvement cost. It is also appropriate to do this, in view of the factors that produced the value increase.

The difficulty has been in too great reliance, probably, upon the older assumptions with respect to land values and the effect of improvements upon them. At the same time too little attention has been given to the equalizing influences of modern transportation agencies, especially the motor vehicle. Population increase probably produces slowly rising values of strategic land sites, but it is a process which may at the same time be undermined, delayed or diffused by transportation improvements. The benefits imputed to any one section from a road or street improvement may be in fact neutralized by extending the road on to some other section. Accessibility, once the great source of advantage from street paving, loses its premium when all the streets are paved and all highways are surfaced, and when fifty miles means no more in time than five or ten miles once meant.

The universal use of the special assessment means that some amount of value increase is always imputed or assumed. Even the courts will not contradict the assumptions of administrative officers on this point, and the consequence is that some part of the cost is always locally assessed when in fact there may be no benefit. The administrative assumption may not always be carefully considered, for the expansionist urge of various groups is always pressing on the governing body, seeking the development of new subdivisions, the widening of streets, and all of the other kinds of improvements which it is hoped will be paid for by special assessment levies.

Various advocates of land value increment taxation have suggested the increment tax rather than the special assessment as a means of financing improvements.⁴ Since the latter is a levy on the value increment produced by the improvement, the main difference is that between general and specific use. Under a general land value increment tax there would be no distinction between the improvement and other causes for the increase in value, but the taxation of the increment would provide, it is assumed, funds to pay for the specific public improvements.

⁴ Cf. E. H. Spengler, "The Increment Tax versus Special Assessments," *Bulletin of the National Tax Association*, Vol. XX, pp. 258-261; XXI, pp. 14-18. (June and October, 1935) and writers cited.

In operation, there appears to be little basis of preference, so far as concerns the financing of a public improvement. That is, if a value increment emerges, it can be appraised and captured under either method. The technique for determining the amount of benefit and for apportioning it among parcels of property may be faulty, thereby causing a regressive distribution of the burden. A general value increment tax would be free of the problem of ascertaining and apportioning the exact amounts created by a specific improvement, but it would be subject in another respect to the same drawback that causes difficulty and leads to inequitable results in the apportionment of a special assessment.

This drawback is in the obligation of the administrator to guess at the volume and the distribution of the increment (or the benefit) in advance of its appearance. The actual effect of the improvement upon property values cannot emerge with sufficient definiteness to be measured until there is opportunity of demonstrating these effects in use after a period of time. Meantime the cost of the improvement must be financed. While the issue of bonds may defer final payment, it involves interest costs that cannot be delayed.

The value increment tax is more likely than the special assessment to throw the burden of improvement costs on the community at large if things go wrong. As long as the increment continues to grow all will be well under either method. But suppose that the increment in land value stops growing before the improvement bonds are paid off. The construction of a new state highway may divert the population and trade increase that was counted on to produce the necessary value increment. Any number of things can happen that would check the anticipated development, as the experience of cities shows. The revenue source for servicing the improvement debt is then dried up. Under the special assessment, there would at least be a lien on definite parcels of property that would cushion the increase of general taxes.

This much seems clear. The communities that were most extravagant in their assumptions regarding the benefit created by local improvements and that acted most liberally on this assumption by heavy borrowing to finance such improvements, were among those that had the greatest financial difficulties during the depression. So many of these eggs never hatch that the wisest policy seems to be that of proceeding with extreme caution on the assumption that every improvement has its benefit. Many do not, and the town that realizes this may not have so many fancy improvements, but its credit will be good and its officials will not have to dance to any tune that the creditors choose to play.

Excess condemnation. There remains another alternative procedure for the financing of local improvements. This is excess condemnation, which has been defined by the leading American student of the subject as "the policy, on the part of the state or city, of taking by right of

eminent domain more property than is actually necessary for the creation of a public improvement and of subsequently selling or leasing this surplus.”⁵ The proceeds from the sale or lease of the condemned property not used for the improvement may be devoted to payment of the cost of the improvement, or for general purposes in case such receipts exceed this cost.

Excess condemnation has been used extensively in Europe and has gained some acceptance in the United States. It is evidently a variant of the land value increment plan, more extensive in scope than the special assessment, but yet not general. The principal purposes for which excess condemnation has been used in the United States have been the following: ⁶

1. To solve the problem of remnants of land in street widening or extensions.
2. To protect the usefulness and beauty of public improvements through the restrictions which the city is able to set up as the surplus land is sold or leased.
3. To make money. This motive has been especially prominent in Europe, but has gained little headway as yet in the United States. All of these motives, or any combination of them, are possible in the same undertaking.

The useful field for excess condemnation is evidently limited to projects that involve a reorganization of land titles, such as street extension or widening, the development of a park, or a reclamation project. It could not be used for draining or sewer projects, or even for ordinary street paving, since none of these involve a radical redistribution of land holdings. It is subject to all of the limitations respecting the emergence of the land value increment that have already been mentioned, and it has the further definite disadvantage of committing the city to a land speculation in order to finance the improvement.

In this policy there are many pitfalls. The condemnation price may be too high; there may be damages other than the land purchase price, on account of loss of good will or trade connections by those who may be dispossessed; sale of the surplus land after completion of the improvement may proceed slowly or at disappointing figures. Meantime the debt service on the improvement bonds runs on.

As a device for capturing the land value increment, excess condemnation is evidently inferior to a general increment tax, and as a device for apportioning costs in accordance with benefits it is inferior to the special assessment, for it will seldom if ever be possible to condemn and acquire on reasonable terms all of the property that may be deemed to be benefited by an improvement.

⁵ R. E. Cushman, *Excess Condemnation* (1917), p. 2.

⁶ *Ibid.*, p. 7.

The privilege is useful, however, and should be in city charters or in municipal statutes, in order to permit the reorganization of land parcels after street extension or widening. This service can be performed without stretching the power beyond its proper limits in an effort to finance the whole cost of an improvement out of the elusive land value increment.

PART III

Public Revenues: Taxation

CHAPTER XVI

Meaning and Development of Taxation

THE SURVEY of the minor sources of public revenues, in the preceding chapters, has cleared the way for a consideration of taxation, which is by far the most important of all revenue sources. Its significance is due not only to the relatively large proportion of the public revenue now supplied by this means, but also to the problems, theoretical and practical, to which it gives rise. The gravity of some of these problems is to be accounted for primarily by the weight of the tax burden, a phenomenon which rests, in turn, upon the immense volume of public expenditures. If expenditures were smaller, tax problems would occasion much less concern.

THE MEANING OF TAXATION

The first task is to discover what is meant by a tax. Economists and judges have tried their hand at defining a tax, with differing results. Some representative definitions by economists are presented below. The first is Professor Seligman's: ¹

A tax is a compulsory contribution from the person to the government to defray the expenses incurred in the common interest of all, without reference to special benefits conferred.

Adams suggests that a tax ²

...is a contribution from citizens for the support of the state.

Bastable has framed the following definition: ³

A tax is a compulsory contribution of the wealth of a person or body of persons for the service of the public powers.

Characteristics of a tax. These statements of the tax concept, which may be taken as typical of the modern economic viewpoint, agree on three points, which may be regarded as essential to any satisfactory definition of a tax.

¹ E. R. A. Seligman, *Essays in Taxation* (1921), p. 432.

² H. C. Adams, *Finance*, p. 301. See also pp. 292, 293.

³ C. F. Bastable, *Public Finance*, p. 263.

A contribution for common purposes. The first point of agreement is that the tax is a contribution from the citizen for general or common uses. Professor Seligman emphasizes, further, that this contribution is enforced, without reference to special benefits conferred. This contrasts the tax with various other levies which the government may make, as the special assessment, which is compulsory but measured by the benefit received, and the fee, which is a non-coercive payment for an administrative service.⁴

The contributory element in the modern tax concept is in contrast, also, with the earlier view which regarded it as a payment for definite services rendered. This view was quite generally held during the seventeenth and eighteenth centuries.⁵ According to some, the principal service conferred was protection, and the tax was the price of this protection. Whatever the service rendered by the state may have been considered to be, the whole transaction of paying taxes, on the one side, and of administering the government on the other, was looked upon as an exchange or bargain, in which each side gave the other a *quid pro quo*. Such an interpretation of the relation of the citizen to the state would most naturally develop when men were beginning to think seriously about the importance and the rights of the individual, and to stress these rights as against the power and importance of the state. The political thinkers of the eighteenth century were leaders in the great movement toward individualism that was destined to sweep over western Europe and America during the later eighteenth and early nineteenth centuries. The bargain theory of taxation was in harmony with the doctrine of natural rights and the theory of the social contract.⁶

Just as the bargain theory of taxation was an outgrowth of extremely individualistic theories of the social order, according to which each person was supposed to provide for his own needs or to pay the government for its services in this direction, so the modern viewpoint in taxation is a product of the growing social solidarity and sense of common social

⁴ See above, p. 226. The terminology of public finance is often loosely used, and in some jurisdictions impositions that have every characteristic of a tax are designated by law as fees.

⁵ Some representative definitions of a tax that illustrate this view were the following:

"The impositions laid on the people by the sovereign power are nothing else but the wages due to them that hold the public sword to defend private men in the exercise of their several trades and callings." Thomas Hobbes, *The Leviathan* (1651), edition of 1886, Part II, Ch. XXX, pp. 157, 158.

"The revenues of the state are a part of his property which each citizen gives in order to be sure of the other part, or to enjoy it in comfort." Montesquieu, *Esprit des lois* (1748).

"The subject, when properly taxed, contributes only some part of his property in order to enjoy the rest." Blackstone, *Commentaries*.

⁶ In pre-revolutionary France the wealthy and privileged classes were largely exempted from taxation, although they enjoyed most of the benefits of government. Under these conditions the benefit theory of taxation was a radical doctrine.

obligation that have characterized human progress during the last hundred years. The contributory element in the modern tax concept emphasizes the greater social unity, and the stronger sense of common burden and responsibilities which are a feature of modern life. The state is an all-embracing social organization. No one can be apart from it, no one can deny his obligations to the community, or his dependence upon the common life. All should therefore contribute to its effective support. This conception of the nature of taxation is inimical to the view that taxes are payments for specific services rendered to the several taxpayers by the state.

From the viewpoint of all citizens, and taking into account all of the services of government, there should be a clear benefit relation between the total of taxes paid and the aggregate of public services performed. This assumes, however, that the objective of government is to do those things, and only those things, that sustain and promote the economic progress of the people. It is quite possible for government to embark upon projects which are of little or no benefit, and to increase taxes to a level beyond that of a fair return in beneficial public services. In other words, taxation may become onerous, which means that government is taking out of the economic system, through taxation, greater value than it returns through its services.

A personal obligation. A second common characteristic of the modern definitions of a tax quoted above is that they make the tax a personal obligation. The state is an association of persons, and it is these persons, as such, who are responsible for its support. This does not mean that all taxes must be levied on persons as objects of taxation. As a matter of fact, taxes are actually based on a great variety of material things, as well as on immaterial or intangible forms of wealth and on rights and privileges. The meaning is rather that the primary obligation to pay the tax is a personal obligation, rather than one which can be said to reside in any material thing or objective fact as such.

This personal obligation to contribute to the state's support is universal and applies to all, whether citizens or aliens, who are subject to its jurisdiction. Thus, the state may assume the right to tax its citizens, whether residing at home or abroad, and to tax all other persons living or deriving advantage from activities conducted within its borders. A tax jurisdiction over non-resident aliens is established if such persons earn income, conduct business or own property within the state. The federal government now goes still further in the case of resident aliens, by taxing their entire income from all sources, with proportionate allowance for taxes paid in another country, provided that country extends similar tax credits to American citizens residing therein. The taxation of non-residents may involve discrimination, however, unless it is done under carefully drawn reciprocity arrangements.

Another aspect of the universality of the tax obligation is encountered in the contention that is sometimes raised by unfranchised persons, or classes, to the effect that since they have no right to vote, they may not lawfully be asked to pay taxes. They were being taxed, it has usually been alleged, without being represented in the assembly that voted the taxes.⁷ Protests of this sort were often made by women property owners prior to the adoption of the Nineteenth Amendment providing for women's suffrage.

Such contentions clearly could not be entertained for a moment. The right of suffrage has never been co-extensive with citizenship, and the possession of this right is not the only test of citizenship. Minors, persons of unsound mind, and disfranchised persons are considered to be citizens and subject to all the laws of the state, without having the right to vote. Suffrage is only one of the privileges of citizenship, and it cannot be said that the legislators and other public officials represent simply those who may be privileged to vote. All persons subject to the authority and jurisdiction of the state are obligated to contribute to its support through the payment of taxes. Indeed, as stated above, there has been no serious question of the right of the state to impose certain taxes upon resident and even upon non-resident aliens, although in the latter instance the practice involves a shift of the basis of taxation from jurisdiction over the person to economic interest. The non-resident alien is taxed, if at all, on his property located within the country or on his income derived from sources within the country. The justification for such taxes must be that the government has afforded some protection or benefit which has made more convenient and certain the use and ownership of property or the acquisition of an income.

The emphasis upon the compulsory aspect of the tax in the modern statement is another point of contrast with the earlier definitions. The implication of the older theories, arising as they did out of the conception of the tax as part of a bargain or contract, was that the taxpayer could refuse the services of the state and so refuse or avoid payment. In the days of the feudal system, when the principal sources of support for the ruler and his establishment were the domains and other possessions held by him, gifts and contributions for state purposes were sometimes made by citizens. These gifts may have been voluntary, prompted by the zeal of the people and their admiration of the ruler. In other cases there may have been tacit understanding that it was better to give than to be levied upon.⁸

⁷ The point was raised, for example, in a suit brought by a resident of the District of Columbia to secure relief from an assessment. Residents of the District have no vote, but this argument against the plaintiff's tax obligation was summarily rejected by the court. *Heald vs. District of Columbia*. See *Bulletin of the National Tax Association*, Vol. VII, June, 1922, p. 304.

⁸ Cf. S. Dowell, *History of Taxation in England* (1888), Vol. I, pp. 196 ff.

A levy for revenue. A third point on which the definitions of a tax given above are in agreement is with respect to the purposes for which a tax shall be levied. This purpose is the provision of revenue for the service of the public powers. The use of taxation may be advocated for other purposes, however, than the provision of public revenue. The propriety of using the taxing power for ulterior objects is discussed in a later chapter. On general grounds the case appears to be against this conception of the proper field of taxation. It would be difficult, and of doubtful social advantage, to define a tax in such manner as to authorize its use for these ulterior objects as well as for the original and fundamental purpose of providing public revenue. It is sufficient here to point out that the modern conception of taxation emphasizes positively that the power is to be exercised for the purpose of providing public revenues, and that it apparently does not give a positive sanction to the use of the taxing power for the accomplishment of ulterior objects. The best that can be said is that the modern tax concept does not actually forbid its use to attain these ends except by implication; hence such a use may be inferred to be proper. It is true that taxes are continually being levied with a view to the regulation or prohibition of certain activities and practices, but it is always difficult to reconcile such operations with the true nature of the taxing power. The discussion of this matter is continued in the following chapter.

Finally it should be noted that none of the definitions of a tax attempt to give a clue to the rule or principle to be followed in the distribution of the tax burden. In this respect there are wisely reticent. No single principle can be employed in the case of all taxes, and the only safe rule is to authorize an elective policy. The development of taxation and the shifting standards of social responsibility have placed the emphasis, first upon one type of tax or upon one rule of apportionment, then on other types or other rules. Economic and social facts are dynamic, and the methods by which the state secures its revenues and the principles according to which the burden is distributed, must be correspondingly plastic.

THE NATURE OF TAXATION

As the formal definitions of a tax indicate, it is a means of taking private income, or private wealth expressed as income or in some other form, for public use. The total quantity of goods produced must support both the people and the government. Taxation is one of the processes by which government diverts a portion of the produced goods to its own ends.

This is not a direct diversion. Instead of requiring the various industries to set aside quotas of their respective products—cement, steel, lumber, and so on—for public use, the people are required to give up a part of

the purchasing power which constitutes their respective incomes. With these funds government buys the materials and pays the workers needed for the public services.

Since all taxation consists of a diversion of purchasing power from the general income stream, it might appear that the simplest way of financing government would be by using a single tax levied on all income. This is, indeed, a possibility. But it would be neither simple nor easy. Though the income stream is a reality, it is extraordinarily complex, consisting of many parts, and its flow involves all sorts of interlocking and duplicating elements. Any attempt to defray the whole cost of government by one comprehensive levy on income would result in great diversities of impact at different points. Such, it is true, is the result of the ordinary methods of taxation, but the present diversities would be still further intensified by the concentration of the entire tax load upon a single tax base.

The method of diverting private income or purchasing power through taxation varies with the different kinds of taxes. For example, property is taxed according to its value, and this valuation may or may not be in relation to the income from the property. Sometimes a parcel of property may be yielding no income to its owner—examples are vacant land and non-dividend stocks—yet, because it can be sold in the market at a price, the owner must provide enough out of other income to pay the tax. Obviously the price of such non-income producing property would be based upon the prospective or potential income, but the owner may have a long wait before this prospect becomes a reality. If his income from other sources in the meantime is not sufficient to pay the taxes, his only recourse would be to sell a part of his property each year in order to pay the tax on the remainder.

Taxes on commodities, such as gasoline and tobacco, are added to the price. Because of the tax, the consumer gives up more of his income in the purchase than he would otherwise. The income tax is based on so-called "net income." In a later chapter the difficulties encountered in obtaining even a part of the public revenue by taxing income directly are discussed.

The essence of the problem of taxation is to determine both how much of the income stream shall be diverted, and also in what manner. More attention has been given to the first than to the second of these questions. This is unfortunate, particularly in a time when the amount required by government is rising rapidly. In such circumstances the manner or method of taxation becomes all-important, for it determines whether the rising tax load can be carried easily or with great difficulty. In view of the fundamental relation of taxation to the economic processes of production and income payment, it is essential that taxation be as completely as possible on a pay-as-you-go basis.

CONSTITUTIONAL ASPECTS OF TAXATION

The central constitutional issue involving the exercise of the taxing power is that of the seat or source of this power. Is it a prerogative of the sovereign or does it inhere in the people who pay the taxes? Viewing the sweep of history in the large, three separate stages may be discerned. These stages correspond with the epochs which mark the emergence, the high noon and the afternoon of constitutional government.

The first stage is marked by a prolonged and bitter struggle between the sovereign and the people over the taxing power. This struggle went on in England for more than four centuries, but it resulted finally in establishing the fundamental right of Englishmen to consent to the levy of taxes. An early landmark in the contest over the taxing power was Chapter 12 of Magna Charta, given by King John in 1215. It is as follows:

Chapter 12. No scutage or aid shall be imposed in our Kingdom except by the common council of our Kingdom, except for the ransoming of our body, for the making of our oldest son a knight, and for once marrying our oldest daughter, and for these purposes it shall be only a reasonable aid.

This document was important, from the standpoint of the history of parliamentary control over taxation in England, rather as a forerunner of that which was to come than as an actual achievement in restricting the king's power over taxation. The common people of England were not represented in the council, and the struggle which culminated in the Great Charter of 1215 was between the king and his barons. Further, all reference to certain important taxes was omitted and as time passed various new taxes were introduced which were not subject to the restrictions imposed by the provision quoted. This concession was, however, a beginning, and, as one writer put it, "the nation, having once taken a sip of the cup of control over taxation, would not be content until at last it had drunk deep at the well itself."⁹

Another great landmark in this struggle occurs in the following provision of the Bill of Rights of 1689:

...levying money to or for the use of the Crown by pretense of prerogative without grant of Parliament for longer time or in other manner than the same is or shall be granted, is illegal.

Between the grant of the Great Charter in 1215 and the enactment of the Bill of Rights in 1689 the English people had pressed steadily for the enlargement of their control over taxation, and their success, evidenced by the establishment of definite parliamentary control in that bill, really meant the conclusive transfer of sovereignty from the ruler to the people. Where the legal and constitutional power of taxation resides, there also

⁹ S. Morgan, *History of Parliamentary Taxation in England* (1911), p. 70.

resides sovereignty. The popular pressure for taxation control had been resisted by the rulers, in some cases diplomatically, and in the case of Charles I, with personally disastrous results.

The second stage in the formulation of the central constitutional issue respecting taxation, which occurred during the high noon of constitutional government, consisted in establishing and determining more definitely the limits within which and the conditions under which the taxing power might be exercised by the chosen representatives of the people, acting as a government. Constitutions, whether written or unwritten, dealt principally with the terms and conditions, the limitations and characteristics of the taxing system. They recognized fully but usually tacitly the principle that the people had the right and the power to consent to the taxes levied upon them.

Thus, the authors of the federal constitution, recognizing the importance of adequate taxation in the formation of an effective government, but forced to recognize also the character of the federal union which they were proposing, set various limits and restrictions upon both federal and state governments, as the following list of the taxation provisions of the federal constitution shows:

Art. I, Sec. viii, par. 1: . . . all duties, imposts and excises shall be uniform throughout the United States.

Art. I, Sec. ix, par. 4. No capitation, or other direct, tax shall be laid unless in proportion to the Census or Enumeration herein before directed to be taken.

Art. I, Sec. ix, par. 5. No tax or duty shall be laid on articles exported from any state.

Art. I, Sec. x, par. 2. No state shall, without the consent of the Congress, lay any duties or imposts on exports or imports, except what may be absolutely necessary for executing its inspection laws; and the net produce of all duties and imports laid by any state on imports or exports, shall be for the use of the Treasury of the United States, and all such laws shall be subject to the revision and control of the Congress.

The first three of these provisions relate to the federal taxing power, the last to the state power. Various other provisions of the federal constitution have been held by the courts to be applicable in taxation, although they were originally drafted as general restrictions against the states. Some of these restrictions apply to both federal and state governments, others to the states only. The "due process clause," which is found in both the Fifth and the Fourteenth Amendments, is operative against both.¹⁰ A fundamental rule of the federal-state relationship is that neither government may use its taxing powers so as to interfere with the essential operations of the other. The broad interpretation of this principle which

¹⁰ In substance, no person shall be deprived of life, liberty or property without due process of law. The language of the Fifth Amendment is general, that of the Fourteenth Amendment applies to the states.

originated in *McCullough vs. Maryland* has been narrowed materially by the Supreme Court in recent years.¹¹

On the other hand, no state shall deny to any citizen the equal protection of the laws, and the citizens of each state shall enjoy the privileges and immunities of citizens in the several states. No state may, by taxation, contravene the provisions of federal treaties. The interstate commerce clause has been construed to mean that the states may not burden interstate commerce by taxation.

This summary of the taxation provisions, direct and implied, in the federal constitution, confirms what was said above, to the effect that they relate to the limitations, conditions and procedure under which the taxing power is to be exercised. The most fundamental underlying question is taken for granted; but to make the control by the people over the purse more secure, a provision was added requiring that all bills for raising revenue, that is, for the imposition of taxes, should originate in the House of Representatives. It was supposed at the time that this body would be more directly and closely representative of the people than the Senate.

The third stage in the central constitutional taxation issue always appears when constitutional government itself weakens or collapses. It is the attempt to deprive the people of their right of controlling the purse.

The suspension or abrogation of constitutions in some countries, and the discontent which agitators are always able to stir up in others during periods of economic stress, have suggested, in the figure of speech used earlier, that the present is the afternoon of constitutional government. Whether it is really the afternoon, with twilight and darkness ahead, or only an eclipse, time alone can reveal. Constitutional government and the guarantees afforded under it have disappeared in some countries that once enjoyed them. The nature of some of the defunct constitutions and the scope of individual rights assured by them may have left something to be desired, but they were an expression, however inadequate, of the democratic purpose. The world's political pendulum has moved far toward absolutism and dictatorship of one description or another. However devised and operated, absolutism in government is much the same, whether in the twelfth or the twentieth century. The people lose, not only the right to consent to the taxes levied upon them, but all other civil rights and liberties as well.

A cynical minority contends that the people of the United States have lost or have surrendered these rights in substantial degree. This is not the case as yet, nor can it ever happen in this country except by abject relinquishment. No man or group is or will be strong enough to take a free people's supreme rights from them by force, but someone may seize that which the people have cast aside as of little value, or which they have been hoodwinked into yielding in exchange for lying promises and the

¹¹ 4 Wheaton 316 (1819). See below p. 297.

pottage of government beneficence. Popular control over taxation is the essence of constitutional government, for no public administration can long endure without revenue. As long as the people retain their hold on the strings of the public purse, their bill of civil rights is secure. Popular acceptance of harsh, unprincipled, expropriatory and severely discriminatory taxation as punitive measures means playing into the hands of those who would destroy all individual liberty.

It should be noted that resort to inflationary devices may enable an administration to keep going for some time without the use of taxation, and that such financial methods may, in effect, be a way of undermining the principle of popular control of policy through the exercise of consent to taxation. Government control of the central banks facilitates credit inflation, for public bonds and notes may be forced into these banks in exchange for deposit credits which will serve for the payment of expenses quite as well as purchasing power obtained through taxation. The danger of abuse of this sort constitutes a potent reason for keeping central bank management sufficiently independent of the treasury to provide resistance against it.

THE ELEMENTS OF TAX JURISDICTION

One of the most difficult questions in taxation is the determination of the tax jurisdiction. What objects does any government have a right to tax? The obvious answer is that the right extends to all objects within the jurisdiction, but there remains the troublesome question as to when or under what circumstances is any given object within or without a particular jurisdiction. The difficulty has been increased by the competition for revenue, which has provided strong temptation to seize upon every available pretext for asserting the right of taxation.

A rule quite generally accepted during the early history of the property tax was based on the distinction between movable and immovable property. Fixed property, such as land and buildings, was taxed where located, while movable property was taxed where the owner lived. This rule was expressed in the Latin phrase "*Mobilia personam sequuntur*," or movables follow the person.

The policy of taxing immovable property where it is situated is still generally followed, under property, business, and inheritance taxes. But the growing complexity of property forms and the ever-increasing intricacy of business activities and relationships have led to numerous modifications of the earlier practice with respect to movables. Many forms of tangible personal property are now taxed where they are located and used, rather than at the domicile of the owner. Intangible property, in general, is still taxed at the domicile.

Taxes based on income, whether personal or business, give rise to

peculiarly difficult questions of jurisdiction, in view of the widespread character of the economic activities by which income is gained. In this, as in all taxation, it is desirable to avoid the discrimination involved in double taxation; yet there is no absolute principle by which tax jurisdiction may be determined. Two principal methods have been followed—one is taxation according to origin, the other is taxation according to domicil. Either rule, generally observed, would eliminate double taxation of income. In the case of business taxes based on income, the tendency is to allocate the taxable income according to the business done, which means roughly according to the origin of the income in the several competing jurisdictions. In the case of personal incomes, the policy is somewhat confused. Most of the states and the federal government tax all residents on their entire incomes, which means application of the rule of domicil; but they also tax non-residents, whether citizens or aliens, on income obtained within the jurisdiction, which introduces the rule of origins and leads to double taxation unless this is guarded against by reciprocity arrangements. It cannot be too often or too strongly emphasized that uniformity of procedure is more essential than the precise method itself, if discriminations are to be avoided.

SOME TECHNICAL TERMS

It is desirable to present in this introductory chapter various technical terms that have become a part of the accepted tax vocabulary, although unfortunately there is not always general agreement as to the meaning that should be assigned to them. This confusion of nomenclature becomes especially unfortunate when the terms with different or uncertain meanings and usage are incorporated into laws and constitutions, for there is frequently a considerable difference in the practical effect of the different interpretations.

Direct and indirect taxation. There is probably greater divergence in the meanings given to the terms *direct* and *indirect* than to any others in the entire literature of taxation. Professor Bullock has collected upwards of twelve different sets of definitions of direct and indirect taxation, scattered through economic literature since the Middle Ages.¹² Modern authorities are in the main agreed in accepting the distinction suggested by Mill, which was based on the intended difference in incidence. Direct taxes are those which are intended to be borne by the persons on whom they are levied, while indirect taxes are levied on one set of persons in the expectation and intention that they will be passed on to others by the process of shifting. This distinction cannot be made hard and fast,

¹² C. J. Bullock, "The Origin, Purpose and Effect of the Direct Tax Clause in the Constitution," *Political Science Quarterly*, Vol. XV, pp. 217, 452. June, September, 1900.

for tax shifting does not go on automatically. Rather, the process is subject to various qualifying conditions, in the operation of which there may be a considerable element of friction, so that the intended results may not always be realized in practice. No dogmatic assertion can be made, therefore, concerning those taxes which are always shifted and those which never are shifted. Nevertheless, this distinction is probably more useful than any other, since it is more generally used and understood than any other. It will be followed, although it should be remembered that the distinction does not always hold.

The subject, object and source of taxation. The terms *subject*, *object* and *source* are also given widely different meanings. The subject of taxation, according to Bastable, is the person affected, and the object is the thing or fact, the objective element, upon which the tax is imposed. Professor Seligman holds that the term *object of taxation* should refer to the aims or purposes of taxation, while the term *subject of taxation* should include both the persons and the things affected by the tax. This is the usage followed by the courts and the legal writers generally. But according to the definition of a tax given by Seligman and other economists, the object of all taxation and of all taxes would always be one and the same, namely to provide revenue for the state.

An objection to the view held by Seligman and by the courts is that it always groups persons with things, since both are regarded as subjects of taxation. If the other conception of these terms is accepted, persons become both subjects and objects in the case of all direct personal taxation, but this limited degree of duplication is preferable to the general confusion that prevails when persons, property, income, business and all else are lumped indiscriminately together as the subject of taxation.

One great advantage in using the term *subject of taxation* to designate the persons affected is that it emphasizes the personal nature of taxation and of the tax burden. All taxes are borne ultimately by persons, regardless of the thing, fact or condition upon which they are based, and regardless too of whether or not the persons affected are aware of the burden. Taxes may be paid out of income or the liquidation of property, but it is erroneous to think of property or income as bearing the burden of taxation, for inanimates obviously cannot be aware of sacrifices. It will promote general concern over the effects of taxation and greater regard for reasonable use of it to distinguish more sharply between the persons affected, as reflected by the burdens imposed, and the innumerable classes of objects upon which taxes are based.

The source of taxation refers to the fund or flow of wealth from which taxes are paid. In the last analysis there are but two main sources of all taxes, incomes and property. It is possible that a tax might be paid in labor service, and under the feudal régime in France and England some part of the public revenue was obtained in the form of compulsory

labor on highways and other public works and in military service. Some of the American states continue to permit commutation of the poll tax by working on the roads, despite the modern program of expensive highway construction. The present exceptions to the statement that all taxes are paid either from income or from property are quite unimportant. Whatever the object upon which the tax is levied, therefore, it is paid by the subject either from his income or from his property by liquidating a portion thereof. The latter does not occur except as a last resort, or to meet extremely heavy taxes such as an inheritance tax or a capital levy upon wealth in general.

In the last analysis the only source from which taxes can be paid is social income, unless the government is willing to accept and to use specific forms of property as a satisfactory payment of the tax obligation. The melting down of property assets by one person means that someone else has purchased this property out of his surplus income, or by means of a bank credit. In the latter case, however, there is the debt at the bank which must be redeemed out of the future installments of the debtor's income, or from the income or sale of the hypothecated property. If this credit is not canceled through repayment of the loan, inflation results. While this condition lasts, it may be a means of paying taxes without drawing on either income or capital. If the property is sold abroad, it remains true that the foreign purchasers must have made payment either from income or by means of credits, with the same ultimate results.

Proportional, progressive and regressive tax rates. Another set of terms refers to the tax rate structure in relation to the tax base. The *tax base* is the object levied upon. It may be expressed in terms of money, as in the case of incomes or of property assessed or valued in money terms; or it may be expressed in some specific measure of quantity, such as pounds, gallons, or thousands of units. Gasoline is taxed by the gallon, cigarettes by the thousand, and so on. The *tax rate* may be stated in different mathematical relationships to the size of the tax base. If the rate is the same, regardless of the amount or size of the tax base, it is *proportional*. A gasoline tax rate of four cents per gallon is proportional, for the rate is the same whatever amount is bought. If the rate increases as the tax base increases, it is *progressive*. The personal income tax is usually progressive, for the rate may be 1 per cent on the first \$1,000 of net income, 2 per cent on the next \$1,000, 3 per cent on the next \$1,000, and so on. It is not necessary that the progression in the rate be the same as in the tax base. In fact, this never happens, for the rate would presently reach 100 per cent of the base, otherwise.

In practice, and in order to avoid the taking of the whole tax base beyond a certain point, as would happen if an unflinching progression were applied, all so-called "progressive" tax rates become proportional beyond some point. That is, they advance by fixed gradations, rapidly or

slowly according to the legislative intention, and end by taxing all of the given tax base beyond a certain amount at the top rate of the scale. Thus, after progression ceases, the rate becomes proportional. When the tax rate increases, but by decreasing increments, it is a *degressive* progression. This effect may be achieved, also, by increasing the amount of the tax base that is taxed at each successive rate. An illustration in income taxation would be: first \$10,000 of income, rate 1 per cent; next \$30,000, rate 2 per cent; next \$50,000, rate 3 per cent, and so on.

If the tax rate decreases as the tax base increases, it is *regressive* or the opposite of progressive. Modern tax laws never provide, deliberately, for regressive rates but some medieval taxes used this method of favoring the wealthy. In practice, some modern taxes are regressive. The property tax rate may be proportional, but if the larger properties are relatively under-assessed, and they often are owing to the shortcomings of the assessment technique, the true tax rate is regressive as between the small and the larger properties in the tax district.

Regression is also used in a wider sense, under which virtually all so-called proportional taxes, and some with progressive rates, can be shown to be regressive. In this sense, the comparison is made between the tax paid and the taxpayer's entire net income. Since net incomes vary widely, virtually every tax paid or borne by individuals except a steeply progressive tax on net incomes, is in effect regressive when compared with relative net incomes. This is really a misapplication of the concept of regression. It is far more popular, however, than the technically correct usage, since it provides a convenient basis for the criticism of any tax to which the critic may be opposed.

CHAPTER XVII

Distribution of the Tax Burden

THE DISTRIBUTION of the tax burden among the citizens involves a statement with respect to the purpose for which the taxes are to be imposed. According to the position taken in this book, there is only one valid purpose which justifies the exercise of the taxing power, namely, the provision of public revenue. However, this viewpoint is not universally accepted. Other purposes are deemed by some to warrant the use of taxation. These purposes involve, in some way or other, the use of taxation to curb, control, or destroy something. This policy is popular with those who believe in general regimentation of the people.

DISTRIBUTION OF THE BURDEN OF TAXATION FOR REVENUE

Taxation for revenue purposes means taxation to finance the cost of the public services. When the revenue objective is the primary goal, there are always certain effects produced by a particular tax or by a system of taxes. This follows from the fact that all taxation involves a transfer of purchasing power from the taxpayer to the state. The subject is discussed further in Chapter XXXVIII. Here it should be noted that the fundamental opposition between the two general attitudes stated above is that in one case the revenue purpose is paramount and the restrictive, regulatory or destructive effects are secondary; but in the other case, restriction or destruction is paramount, while the revenue produced is a minor matter.

There is no single, absolute rule that can be laid down regarding the manner in which the tax obligation of the several citizens should be determined. The standard that would probably have most general acceptance is equality of taxation. This standard may be derived from the emphasis upon various other aspects of equality under the law. For example, all persons have an equal right to be citizens, and as citizens they have equal privileges in the use of public services. They have equal rights to protection, to the use of the highways, and to all other privileges assured by the law and the constitution. All persons of voting age have the right to vote, unless disfranchised for a good reason, such as conviction of a felony or being of unsound mind. There is an equality of

privileges, likewise an equality of responsibility. The general concept of legal equality in many other essential matters supports the idea of equality in taxation.

What constitutes equality of taxation? Students have been searching for an answer to this question for a long time. They have found various answers, but none of them can command unanimous support as being the final one. Any answer, if applied, becomes the key to a method of distributing the tax burden. An examination of the principal solutions which have been offered to the puzzle of equality of taxation will reveal the kind of thinking that has been done.

The benefit theory of taxation. Since the citizens, as a group, pay for the services of government, and thus pay collectively for the benefits which the public services provide, the idea that each person should pay for his share of these benefits has always had a certain appeal. It is clear that in the whole range of public activities and services, all of which are supposed to be beneficial to the community in some way or other, there is a distinction between those services which are definitely beneficial to a person or group, and those which are of common benefit. Every form of public service is a mixture of specific individual and common benefit, but in some cases the individual benefit is sufficiently obvious and material to be measurable.

There is a tendency to place the services of this character in a separate class and to cover their cost by means of some sort of special charge. For example, local public improvements which benefit adjoining or adjacent property may be paid for by special assessments. Clerical services such as registration of deeds are paid for by fees. In the case of special highway facilities, such as the Holland Tunnel and the Pennsylvania Turnpike, tolls are collected from the users. The consumers of water, electricity and other services supplied by government-owned plants pay for the quantity used according to rate or price schedules.

Numerous additional illustrations may be found, and it is entirely possible that other services, notably fire protection, could be put wholly or partially on a direct benefit basis of support. None of these special benefit charges are called taxes. If it were feasible to measure each person's share of the benefit derived from every other governmental service, it would be feasible to collect from each a tax to cover the cost of his share. No method of measurement for this purpose has ever been devised, and it is quite unlikely that one will be. Moreover, even if this were possible, there are many who would not be satisfied that taxation according to benefits constituted an acceptable answer to the problem of equality of taxation.

The ability theory of taxation. The quest for equality of taxation has also proceeded on another assumption, namely, that taxes should be imposed according to ability. Adam Smith gave strong impetus to this

line of thought, which was expressed in the first of his maxims on taxation as follows: ¹

The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities, that is, in proportion to the revenue which they respectively enjoy under the protection of the state. . . . In the observation or neglect of this maxim consists what is called the equality or inequality of taxation.

Adam Smith evidently thought that he had provided a clear and simple answer to the problem of equality of taxation. His answer was that everyone should be taxed as nearly as possible in proportion to his revenue. He does not define *revenue*, but he probably meant total revenue or total income. There is no reason to suppose that he had in mind the complicated and unreal concept which is labelled "individual net income" in modern income tax laws.

Even so, the criterion of equality which Smith proposes could be applied, in practice, only if all revenue were to be provided by a single tax on income. Such was not the case, even in Smith's time, and it would be entirely impractical today in view of the enormous public revenue required. The modern income tax is not a suitable instrument for obtaining all revenue needed, or for determining, with finality, who should and who should not contribute to the cost of government. For example, it is possible, merely by changing the rules as to deductions and exemptions to alter greatly the number of taxpayers and the amount of their taxable income. It does not follow that all who at a given time may be exempt from income tax should pay no taxes of any sort.

The total amount of tax that would be paid by each person under the existing diversified taxes could probably be ascertained, but only with great effort. The further task of relating this total in each case to the individual's income, with a view to ascertaining in what ratio to income it stood, would be formidable. In practice none of these things is done, or even seriously proposed. The discussion of ability, and the references to it as a guide to tax policy, have been confined largely to the income tax as if it were, in fact, the sole method of determining the tax contribution of the several citizens.

In its most elementary and literal sense there is no mystery about the economic concept of ability.² It means the possession or control of wealth or income. So far as the ability to pay taxes is concerned, it would be measured only by such wealth or income as is received in money. Taxes must be paid in cash. Hence, those forms of real income which never materialize in cash are no part of one's ability to pay income tax, however

¹ Adam Smith, *The Wealth of Nations*, Cannan Edition (1904), Vol. II, p. 310.

² The following discussion of ability is taken largely from *The Tax Review*, April, 1943, published by The Tax Foundation. By permission.

much they may contribute to the recipient's scale of living. Illustrations of non-cash income are the produce of gardens and farms consumed by the producer and his family, the shelter provided by an owner-occupied residence, and the corporate shareholder's equity in undistributed earnings.

Exclusion of these and similar items from income tax returns has often been criticized, but it is obvious that their inclusion would frequently lead to extreme hardship, to say nothing of the administrative difficulties involved.

The amount of income received is commonly regarded as the best indicator of ability. Property of any sort that yields no current income is ordinarily carried as an asset, the value of which is determined with reference to prospective earnings or income. Under the property tax, all property is assessed and taxed whether or not it is currently producing income. The theory of this tax evidently involves the assumption that ability is indicated by assets rather than by income. The policy of taxing non-income-producing property can cause unfortunate consequences. In the case of timber land, for example, it may induce excessive cutting in order to finance the tax bill or to terminate an accumulating tax charge as promptly as possible. In other cases, it may force a transfer to those with sufficient cash resources to carry the taxes pending the emergence of income from the property.

It is clear that any ability which is measured or indicated by income can exist only with respect to income in hand. That is, when one has received a pay check or a dividend check, he has an ability to spend which is measured by the amount thereof. He can then proceed to pay his bills, to make purchases, or to pay taxes. When that money has been spent, he is through until more comes in, except as he may mortgage future receipts by arranging a loan with a bank or personal finance company.

Two important characteristics of this relationship of ability to income should be noted. The first is that ability is transient. The ability to do anything with money endures only while the money is in one's possession. When it is gone, by having been spent, or lost, or given away, there is no longer an ability to do anything at all with it. If it were otherwise, if the fact that in the past one had been in possession of a given sum were to mean that the ability represented by this sum is still existent, then it could be drawn upon to pay taxes or accumulated bills. If more revenue were needed, government could go back two or five years and levy on that ability.

Merely to state such a proposition reveals its absurdity. It serves, however, to emphasize that the only sensible interpretation of ability is to regard it as a function of current income. A portion of any income item can be taken in taxes as it is received, or while it is in hand, or as it is spent. A tax imposed at any point from the receiving to the spending

may properly be considered to be taxation when and as there is ability.

The second characteristic of the relationship of ability to income is that such ability as may be indicated by income is to be measured by the rate of income flow rather than by the income aggregate over a period of time. Each recipient of income will have received a certain amount in the course of a year. Ordinarily, it is received in a series of installments and not in a single, lump sum. Regardless of the annual total, the degree of ability is more correctly indicated by the size of the several installments than by the sum of these installments over a year.

For example, a salary of \$3,000 a year represents \$250 a month, and a salary of \$12,000 a year is \$1,000 a month. In so far as it is intended to differentiate between the two incomes for tax purposes, the proper basis would be the respective monthly installments and not the annual totals. To be sure, the ratio in each case is as 1 is to 4; and it would follow that the \$12,000 salary would be subjected to four times as much tax as the \$3,000 salary under any tax rate that is proportional to income. When the two rates of income flow are considered, such a tax relationship is more likely to be acceptable than when the two annual totals are compared. An income of \$12,000 a year looks big. It suggests a much greater ability to pay taxes or to spend for anything else than \$1,000 a month. To many it suggests more than four times the ability of an income of \$3,000 to do these things, although arithmetic tells otherwise.

That is, ordinary arithmetic says otherwise. There is a political arithmetic which is invoked to show that an income of \$12,000 represents more than four times the ability to pay taxes that is represented by an income of \$3,000. In the market, \$12,000 will buy only four times as much as \$3,000, whether it is expended on goods in general or on a particular commodity. When it comes to taxation, however, it is argued that a different measure of so-called "ability" is to be used. More than four times as much of the \$12,000 can, and therefore must, be spent on government service as is required to be spent out of the \$3,000.

This result is accomplished by the use of progressive tax rates. The theory and the consequences of progressive taxation are considered presently. Here it is sufficient to note that no one knows for certain just how much faster than income ability increases as the income rises, if at all. Therefore, there is no just or perfect progressive tax rate scale. Every such scale is a product of guesswork and of political or fiscal expediency. And where expediency is the basis of policy, it is easy to lapse into injustice.

As against the wholly speculative character of any progressive tax rate scale, a tax that is proportional to income is an approximation to relative abilities that is incontrovertible. If one person has ten times the income of another, he has ten times as much for spending, and hence he has ten times the ability of the other to do anything whatsoever with his

income. Under a proportional tax rate he would pay ten times as much tax. After each has paid such a tax, the one has ten times the ability of the other, insofar as income is taken as the measure of ability.

Here, of course, is the rub. It is the inequality of incomes that is really under attack. Proportional taxation of incomes is rejected, not because it is defective as an expression of the ability principle, but because it leaves undisturbed such inequality of incomes as may have existed before the tax. The real goal, which is the equalization of incomes or of wealth through taxation, is wrapped up in a package labeled "taxation according to ability."

It may be that there is an inequality of incomes greater than the inequality in the innate capacities of individuals. Of this there can be no positive assurance, and certainly there can be no accurate measure. Further, no progressive tax rate scale makes any pretense whatever of equalizing merely such discrepancy of this sort as may exist. Even if this could be done, it would come too late to correct the causes of the inequality.

The popular interpretation of the ability to pay taxes has been limited to the matter of income; hence the unfortunate emphasis upon the tax rates. There are other matters that also bear upon the question of ability to pay tax. These are the certainty of the amount of tax and the convenience of the taxpayer in making payment. Adam Smith dealt with these in his second and third maxims of taxation, having made taxation in proportion to ability the subject of his first maxim. He went so far as to say, indirectly, that certainty is the most important rule of all, for he said that a small degree of uncertainty was a greater evil than a considerable degree of inequality.

Convenience and certainty have been given greater recognition through the enactment of the Current Tax Payment Act of 1943. But there are other taxes than that based on income which also satisfy these requirements of a good tax. Sales and excise taxes do so because they apply the principle of installment tax payment to the *nth* degree, and the individual taxpayer is always fully current in his tax payments when he has made his last purchases for the year. Moreover, he has no bother or worry over tax returns.

Progressive taxation.³ Progression in taxation means that method of adjusting the tax rates whereby the rate becomes greater as the size of the tax base increases. Its principal use in this country is for the taxation of incomes and estates. As applied in the case of income tax, it means the taxation of the first installment or section of an income at a certain rate, taxation of the second section of the income at a higher rate, or the third section at a still higher rate, and so on. This method is found in the income

³ The material in this section is taken from *The Tax Review*, May, 1943, published by The Tax Foundation. By permission.

surtax, and the surtax income brackets constitute the sections or portions of income which are taxed at the various rates.

It should be noted that, in practice, the tax rates are not progressive throughout. It is customary to exempt a certain amount of income at the bottom of the income scale, although this is a purely conventional concession and its allowance has nothing to do with the theory of tax progression. It is also customary to halt the progression at some point short of 100 per cent, but this likewise has nothing to do with progressive tax theory. In the 1944 Revenue Act the top rate of surtax was 91 per cent, levied on all surtax net income in excess of \$200,000.

The advocates of progressive taxation fall into two major groups. One group consists of those who see in this method of taxation a means of providing public revenue according to some standard which they regard as equitable. In the other group are those who regard it as an excellent device for the destruction of the private enterprise system and the inauguration of a socialist régime. Unfortunately, the effects of progressive taxation are not dependent upon, nor determined by, the motives of those who believe in its use. In consequence, the first group becomes, unwittingly, a collaborator with the second group, although its members would indignantly deny any affiliation or sympathy of purpose.

Those who regard progressive taxation as a proper and suitable method of determining the respective contributions of the citizens toward the support of government usually base their case upon the ability-to-pay doctrine. They interpret this doctrine to mean that the person who has a large income is better able to pay tax than the person who has a small income. This ability, it is assumed, increases faster than the size of the income; hence it is concluded that the tax rate must likewise increase with the size of the income in order to keep pace with the growth in ability as income expands.

The difficulty with this theory is that there is no standard by which to distinguish a good progressive tax rate scale from a bad one. That is, there is no way of deciding upon the particular scale of rates and the particular size of income brackets to which these rates apply, in order to achieve the most equitable relation of tax burden to ability. It is impossible to ascertain just how much faster ability increases than income, and there can be no certainty whatever that the relation between ability and income is the same in the case of all individuals or in the case of different kinds of income. On the contrary, it is extremely likely that the ability-income ratio varies greatly among individuals having the same income, and that it varies greatly among different kinds of income.

Since the federal income tax began, in 1913, the progressive surtax rates have varied as follows: In the act of 1913, the surtax began at 1 per cent on net income from \$20,000 to \$22,000 and rose to 6 per cent on income in excess of \$500,000. In the act of 1926, the surtax started at 1

per cent on the income between \$10,000 and \$12,000 and rose to 20 per cent on income in excess of \$100,000. Under the acts of 1936 and 1938, the surtax rate was 4 per cent on the income between \$4,000 and \$5,000 and 75 per cent on the income in excess of \$5,000,000. In the war tax acts the progression has been steepened greatly.

It has been characteristic of the federal income tax that the income installments or income brackets have been much smaller in the lower than in the higher levels of income. Thus, rate increases have ordinarily been made with each \$2,000 of additional income up to \$16,000 or \$18,000. Thereafter the income brackets have been widened for a time to \$4,000, then to \$6,000, to \$10,000, and finally to \$50,000 or more as the size of the income increases. Interpreting these income brackets and tax rate increases in the light of the ideological defense of progressive taxation, it would appear that the ability to pay income tax increases most rapidly in the income range from \$4,000 to \$18,000 and that this ability decreases relatively thereafter as the total income increases.

Since there is no standard whereby a choice can be made among progressive rate scales, it follows that one scale is just as good as any other as an application of the principle. A progression which rises to a tax rate of 100 per cent on all income in excess of \$25,000, or even in excess of \$5,000, is quite as defensible in terms of the vague and half-baked theory on which the entire system rests as one which imposes a top rate of 5 per cent on all income in excess of \$1,000,000.

Advocates of progression as a revenue device will contest the preceding statement on two grounds. First, it will be said that the revenue needs should determine the precise scale used and that a perfect adjustment to ability at all times is not necessary. On the hypothesis that some progression is always better than none, this view would provide for the tax to approach as near to some highly theoretical standard of ability as the budget requirements might demand. Presumably also, it would allow for relaxation of the tax rate scale in periods of budgetary surplus. That is, the scale actually used at any time would be entirely a matter of revenue expediency.

But, there is a long-range view as well as a short-range view of the revenue aspect. Temporarily, it is always possible to squeeze a little more revenue out of the larger incomes, a process limited only by the amount to be realized through their complete confiscation. The principal effect of the modifications of the income tax during the 1930's was an addition to revenue by more squeezing at the top and a steady movement toward the goal of complete confiscation above some moderate income ceiling. In the long run, an excessive progression of tax rates is quite capable of destroying the revenue productivity of any tax base to which it is applied.

Second, it will be said that the progressive rate scale should always be reasonable. But, what is a reasonable progression? To those who have

less than \$5,000, it may seem entirely reasonable that no one should be permitted to have more than that amount after taxes.

The obvious fact is that, viewed simply as a revenue device, progressive taxation is an extremely dangerous fiscal instrument for the reason that there are no natural or self-operative checks to guard against abuse. The American experience reveals that there is no degree of progression beyond which those not affected by the progressive rates would be moved to protest on the general ground of inequity. There is no convincing basis for such protest under any scale of rates, since no one knows anything about the relation of so-called ability to income. The only logical stopping place, according to the current ability theory, is at the complete equalization of incomes by a confiscation of all incomes in excess of the lowest amount received by any one. As long as any inequality of income remains, it can be as plausibly argued that these larger incomes, however small their absolute amount, indicate some excess of ability to be levied upon, as it can be that existing inequalities of income indicate differences in ability.

But, even as a revenue device, the current application of progression is a fraudulent form of taxation according to ability. Since the ability doctrine as now applied postulates that all of the items of income received over a fiscal period of twelve months must be added together in order to determine just how able the several individuals are to pay tax, the taxpayers are obliged to defer final ascertainment of their tax liability until after the close of the period in which the income was received. This process naturally compels them to delay tax payment until the income to be taxed has been spent or is likely to have been spent. In reality, this is the reverse of taxation according to ability, for ability comes with the receipt of income and goes with its spending or other disposition. There can be no kind of taxation according to ability which does not recognize the fact that once income has been spent, invested, lost or otherwise disposed of, all that remains is the record of what was received. For a large proportion of the taxpayers, the present policy of progressive taxation is no more than the taxation of a sum in arithmetic.

Because there is no sure definition of the limits to progression, no firm basis of its "reasonable" use, no protection against its unconscionable abuse, those who uphold the system as a revenue device are playing into the hands of the group which would use progressive taxation as the means of destroying private capitalism and ushering in the collectivist state. Here, at any rate, is a clear case for tax progression, the only clear case for it that can be made. In this view, the more drastic the tax rate scale, the more quickly and certainly will the desired result be accomplished. For progressive taxation can and will produce these results, and the arguments of those who wish to apply it to this end make far better sense than do those used by the Pollyanna tax theorists who seem to

believe that it is possible to eat the seed-corn and also, at the same time, to plant it.

The destructive effects of severe progressive taxation should be apparent to all who are capable of even a slight understanding of the nature and the operation of the present economic system. It is of little avail to plead that this method of taxation should never be carried to such an extreme, for experience has demonstrated that it inevitably will be so extended, since those who presumably benefit vastly outnumber those who are most affected by it. As one writer has put it, the popularity of progressive taxation is traceable in no small part to the opportunity which it affords to place added burdens on the group which, while economically strong, is often politically weak.⁴

Among the essentials for the vigorous operation of the private enterprise system the following are significant here:

1. The provision of a large and ever-increasing supply of capital;
2. The application of this capital in a great variety of enterprises involving varying degrees of risk.

In order to assure the requisite flow of funds into the creation of new capital and the maintenance of existing capital, it is necessary that those who successfully weather the risks involved should be permitted to keep such profits as are received as a result of that success.

Progressive taxation can be, and usually is, pushed to a point at which these conditions for the maintenance of private enterprise in a vigorous and flourishing condition can no longer be met. The virtual confiscation of all income above a moderate level robs the capital fund of its principal source of supply, and at the same time it destroys the incentive to take the risks of new or hazardous investment. Having thus paralyzed the process of private saving, investment, and initiative, it becomes an easy matter for the government to assume, first, control, then ownership and direction of the economic factors of production. The most elementary principle of aggression in any sphere is to soften the opponent before engaging him in conflict. Progressive taxation is the most effective possible way of softening the enterprise system before moving in to take it over into a collectivist régime.

At this point a curious lapse in logic suffered by the ability theorists is of definite value to the collectivist cause. It is frequently said, in justification of steep progression, that the person with a large income will still have enough left, after paying the tax, to provide for his personal needs. Hence, the conclusion that even very heavy tax progression can involve neither injustice nor harm to the economic system.

If it were true that there is no other important use for income than

⁴ R. M. Haig, "Taxation," in *Cyclopedia of the Social Sciences*, Vol. XIV, pp. 539-540.

to minister to the personal gratification of its recipient, then the case for government expropriation of it would be on better ground. But, there is another highly important use for income in the support and enlargement of the capital fund. This use is so vital to the maintenance of production and to the advance of the general well-being as to be superior to any use which government is likely to make, in ordinary times, of the funds so taken. Public expenditure of the proceeds of progressive taxation is for ordinary current operating purposes, and the proportion of the tax revenues spent to create self-sustaining public enterprises is negligible. Private investment of these funds adds to the nation's productive capacity. The effects of the public current purpose spending quickly wear off, while the effects of private investment spending endure while the capital goods thereby provided remain in use.

A curious but impressive parallel may be cited by to support the above statement. Mass unemployment, as a chronic phenomenon, has appeared in England, the United States, France, and Germany concomitantly with the increasing weight of progressive taxation of incomes and estates. A vicious spiral has operated as follows: Under the paralyzing effects of progressive taxation, the driving force of enterprise was weakened and a relief problem emerged. The effort to provide funds for relief through heavier taxes on the "rich" increased the volume of unemployment and made more relief necessary. The more these taxes "soaked the rich," the more unemployed there were for whom provision had to be made. Unemployment cannot be lessened merely by providing relief. The way to reduce it is to provide more jobs; the way to provide more jobs is to stimulate enterprise to engage in production; and the way to stimulate enterprise is to give assurance that those who take the risk of investing capital and producing goods shall be permitted to keep a substantial part of such earnings as they may receive. The present methods of taxation provide definite assurance to the exactly opposite effect, namely, that he who makes a dollar in business must expect to surrender a large part of it to the government.

If it were not for the element of class prejudice and class hatred introduced by the socialist controversy, it would be much easier to gain general support for the proposition just stated. There is excellent ground for believing that with a restoration of the incentives which motivate and energize the private enterprise system, jobs can and will be provided for all who are willing and able to work. True, this will mean that some will have larger incomes than others, but the most important thing is that everyone will have more income, and will be able to enjoy a higher standard of living in terms of real income, than will be possible while enterprise languishes in the strait-jacket of repressive and burdensome taxation. It is impossible to conceive of a program that would more effectively vitalize and energize the productive forces in this country than the

announcement of a firm and definite public policy of eliminating the excesses and abuses of progressive taxation. The National Resources Planning Board has issued the prospectus of a huge program for the post-war period which omits all reference to the fundamental issue of tax reform and relies entirely upon further large deficits, a vast expansion of the public debt, widely extended paternalistic supervision and control of economic activities. This program, coupled with the prospect of continued, paralyzing taxation and public debt inflation can induce only resignation and despair.

It would seem a fair and reasonable statement that the remarkable advance of the American scale of living in the past generation has been made possible by the rise of a long list of large industries—concerns large enough to develop and apply the methods of mass production. The history of American business makes it clear that the typical and characteristic way of creating large business units is by the “plowing back” of earnings, the reinvestment of profits. It is true that in this process some persons may eventually amass substantial, even large, fortunes; but the continual growth of a business through the process of reinvestment of earnings has resulted, over and over again, in a large volume of employment, a huge total of wages, and a steadily lower price for some article which contributes to the comfort, the pleasure, and the well-being of millions of consumers.

One way to visualize the paralyzing and destructive effects of progressive taxation is to assume that this kind of tax system, even with rates such as were levied in 1938 and 1939 (i.e., prior to the war tax acts) had been in effect since 1900. Then, on the basis of this assumption, one should ask: How many automobiles would this country have today and at what price would they sell?

In this writer's opinion, the answer is clear. There would be only a few and the price would be high. Certainly, there could have been no such growth and development of the automobile industry as actually did occur. The record of Henry Ford should provide convincing proof. The manner of the growth of the Ford Motor Company is well known. It was created entirely by “plowing back” the earnings. A tax system which would have taken a large part of these earnings for the current, and possibly the foolish expenditure purposes of government since 1900 would have effectively stunted the growth of this company. Such a result would have had the approval of those who set the equalization of wealth and income above every other consideration, but it would have been a great tragedy for the millions who have had their living standards expanded by the incomes created by Henry Ford and by the pleasure and convenience of the sturdy, inexpensive, highly practical automobile which this great pioneer in a great industry was able to produce.

The world of the future has many other potential products that can

and should be made available for all. While the people are so shortsighted as to retain a tax system which so effectively and completely destroys both the source of the capital funds and the incentive to search out the best and cheapest form of these products as does progressive taxation, they can no more materialize than could the automobile, if Henry Ford had been obliged from the beginning, to give over to the government 88 per cent of all income in excess of \$200,000 a year.

The American people face a serious choice here, one which involves their destiny as certainly as any foreign battle field or post-war peace conference. Concretely and in terms of an historical parallel, it is the choice between the Ford fortune and the Ford automobile. If they should decide that there shall be no more fortunes, they will also thereby decide that there shall be no commodities of mass comfort and enjoyment other than those now known. A few large fortunes would appear to be a small price to pay to gain the full benefit for all of the creative and productive capacity which can be stimulated most effectively and most certainly by allowing those who succeed to keep the fruits of their success.

DOUBLE TAXATION

Another aspect of the problem of a proper distribution of the tax burden is that which is presented by double taxation. By this is meant the taxation of some, but not all, objects twice over by the same or by coördinate jurisdictions. In a certain sense there must inevitably be multiple taxation, since the source of all taxes must be either income or accumulated wealth. The tax system, national, state and local, is extremely diversified and all of these taxes are paid out of rent, wages, interest, profits or by the liquidation of property as such. So far as the sources of taxation go, double and multiple taxation is certain as soon as more than one tax is imposed which must be paid from any one of these shares of income, or from wealth. In another respect, double taxation is encountered whenever more than one tax is imposed on any group of taxable objects such as land, income, or commodities. Conspicuous instances are the taxation of property for both local and state purposes, the taxation of incomes and inheritances by both federal and state governments, and the taxation of the same property or income by more than one state.⁵

The occurrence of double or multiple taxation affects the distribution of the tax burden as among individuals. Since federal, state and local governments must be supported by taxes on the wealth and incomes of the whole people, some duplication is inevitable, unless there is to be

⁵ Cf. *Report of a Sub-Committee of the Committee on Ways and Means Relative to Federal and State Taxation and Duplications Therein* (Washington, 1933, 72nd Congress, 2nd Session), pp. 186-188 for a summary of the extent to which the same groups of taxable objects are taxed by federal and state governments.

rigid observance of a scheme of segregated revenue sources for the respective jurisdictions.

Discrimination. Two major issues are involved in double taxation. One is discrimination, the other is the weight of the combined taxes. Double taxation becomes inequitable only when it is discriminatory. If all persons who own land or receive incomes or buy cigarettes are taxed more than once thereon, under substantially the same procedure, no discrimination results; but if some are taxed once, while others similarly situated are taxed twice, the result is discrimination.

The crucial part of this test is the similarity of circumstance. An illustration may aid in defining and establishing it. Taxes on personal incomes are levied by the federal government and by about one half of the states. The resident of New York pays two taxes on his income, state and federal, the resident of New Jersey pays only a federal tax. It is clearly double taxation for the residents of New York, but is it discriminatory? The answer is "no." There is no federal discrimination, for this law applies in all states. New York taxes all of its residents under uniform provisions and procedure. The fact that New Jersey does not tax incomes does not make the New York income tax law discriminatory in its application. It would be a curious result indeed if the New York income tax law were held discriminatory against New York's citizens for the reason that New Jersey did not tax incomes.

If, however, New York should tax the incomes of all residents, and also the income of non-residents received within the state, and if New Jersey should tax the entire incomes of all residents, there would be double taxation of some incomes. Those residents of New Jersey who receive income in New York would be taxed on that income there, and again on the same income by New Jersey, while the other residents of New Jersey would be taxed only once by a state on their incomes.

Similar possibilities of discrimination exist in the case of other taxes. The states have sought to assert tax jurisdiction where revenue could be found, without always giving due regard to the claims of other states. There is no absolute rule or principle of situs and the conflicts of tax jurisdiction have been and are being resolved in two ways. One is through the courts, which have arbitrated these disputes in a great mass of decisions. The other is through reciprocal legislation. The hypothetical double taxation of income by New York and New Jersey, mentioned above for illustrative purposes, would not in fact occur if New Jersey were to tax personal incomes, for the New York income tax law has always provided for reciprocal exemption of non-resident incomes in the case of other states according similar treatment to residents of New York.

The method of reciprocity is far better than that of adjudication. Because it is slower, it is therefore less likely to prevail with respect to all taxes, since the existing conflicts are being taken to the courts and

settled there in some fashion, albeit at times unsatisfactorily, before reciprocal legislation can be secured.

The weight of taxation. The second major issue involved in double taxation is the weight of the combined taxes. Even if there be no discrimination, and there is none in the case of the federal-state tax relationship, the duplication may be objectionable by reason of the aggregate tax load imposed. Uncontrolled and ill-considered expenditure has created a pressure for revenue that has forced federal and state governments to exploit severely certain productive sources of revenue and has led each to disregard the legitimate claims of the other. The federal government has become the worst offender here, for its rates on income, individual and corporate, on tobacco and on estates, to mention only conspicuous cases, have so closely approached the complete confiscation level as to leave but little room for state taxation of these objects.

The remedy for this situation is clearly a return to sanity in public expenditures. The critical attack should be designed to accomplish this objective rather than to eliminate all taxation of the same classes of objects by both federal and state governments.

There have been some instances of international double taxation, especially under income and business tax laws. The elimination of such discriminations depends on international comity and the development of an acceptable basis for the reciprocal adjustment of national tax systems so as to avoid them.⁶

TAXATION FOR NON-REVENUE PURPOSES

The use of taxation for purposes other than revenue means its use to curb, regulate or destroy. Such use means that there need be no consideration of equality, and in fact no consideration of tax burden in the usual sense of that concept. There is no question of any sort of equivalent in public services, for the main purpose of the tax is not the support of these services. Nor is there any question of public revenue, for the more effective the restrictive or destructive influence of the tax, the less revenue there will be.

The non-fiscal purposes of taxation are part of the larger doctrine that finance in general is but a tool for the accomplishment of social objectives. This doctrine dispenses with all criteria formerly supposed to be useful and necessary as guides to the propriety, wisdom, or soundness of taxation, public borrowing, or public spending. Inevitably, also, it

⁶ The initial move in the formulation of such a program has been taken by the Financial Committee of the League of Nations, which has received from a sub-committee a *Report on Double Taxation*, with special reference to its international aspects. See also M. B. Carroll, *Double Taxation Relief, A Discussion of Convention Drafted at International Conference of Experts*, 1927, published by the Bureau of Foreign and Domestic Commerce, Washington, 1928.

dispenses with popular control of the public purse and with the democratic process of formulating and executing fiscal policy. It is a doctrine suitable to the dictatorial super-state, in which the people are told what is to be done for them—and to them—instead of being asked what they would like to have done for them on the assumption that they would be willing to pay the bill. Since the taxing power can be utterly destructive, its significance as an instrument for the execution of any dictatorial policy is obvious.

There is no effective restraint in the constitution upon the non-fiscal uses of taxation, for that instrument sets no limits upon either the amount or the purposes of the taxes levied. The Supreme Court has occasionally rejected taxes that were obviously imposed for other than revenue purposes, but it is reluctant to pass judgment upon the legislative intent. By labelling any sort of regulatory or destructive tax as a revenue measure, and by inserting enough revenue purpose window dressing, it is safe to assume that the Court would not interfere.

The theory that the taxing power may properly be used for any sort of regulatory or destructive purpose has no room in it for safeguards against misuse or abuse of that power. Any use of it, however injurious from the standpoint of its effects as a tax, is justified by those bent upon drastic regulation or destruction, as a means to the end which, in their opinion, is more important than the effects of the tax.

This general viewpoint is well expressed in the following statement by an English writer: ⁷

There is, in fact, no sound reason why taxes should not be levied with a view to some social advantage, whether to check harmful or useless luxuries, or to limit opportunities for drunkenness, or to levy on tobacco users rather than on bread users; to stimulate production or to avoid checking production; or finally, to alter the distribution of wealth to the general advantage.

This is a good illustration of how the paternalistic state is expected to use its taxation paddle on its bad children and to pass out its taxation lollipops to its good children.

Arguments against non-fiscal taxation generally. First, taxation for non-fiscal purposes violates the modern conception of the true nature and purpose of taxation. The definitions of a tax, quoted in an earlier chapter,⁸ without exception stressed the revenue purpose as the justification of taxation. Every instance of tax collection means the taking of private wealth without direct compensation. All taxation is in essence confiscatory whether the rate be low or high. Even if the greatest care be exercised in the selection of taxable objects and in the procedure of tax administration, the operation of a tax system involves more or less

⁷ R. Jones, *Taxation Yesterday and Tomorrow* (1921), p. 130.

⁸ Cf. above, pp. 245-249.

of arbitrary decision and action by assessors, collectors and other officials. The only adequate and convincing defense for action that is essentially and inherently confiscatory in nature is that revenue is needed to support the legitimate public purposes of government in the common interest of all.

Taxation for the primary purpose of obtaining revenue has economic and social effects which may be in some degree indirect, remote and incalculable, however skillfully designed and administered may be the revenue system. The wise use of taxation requires that these effects should be estimated and anticipated as completely as possible, in order that the methods employed may have the least deleterious effects. When taxation is used deliberately for the accomplishment of social or regulatory objectives, a vast amount of guess work is inevitable as to the final effects, assuming that the regulating agency is not completely indifferent to these results.

Second, it is impossible to apply the canons of fair and equitable taxation when regulation or discrimination are the primary purposes. Neither benefit nor ability can be reckoned with in punitive taxation. While the tests of ability or benefit, and the other accepted requirements of reasonable taxation are not yet perfect, either in theory or practice, the striving after such principles is a logical necessity in view of the essentially confiscatory nature of all taxation.

Third, it is well known that the construction of an equitable tax revenue system calls for legislative ability of a high order, and that the administration of taxes is a task of enormous complexity and difficulty. Extensive use of taxation for regulatory and discriminatory purposes means either the erection of a costly and relatively unproductive administrative machine, or the overloading of the regular tax administration to a point that will endanger the adequate performance of its legitimate functions. As this practice proceeds, Adam Smith's picture of the odious and oppressive visits, the horde of officials, the prying into private and personal affairs, and the vexations of cumbersome and expensive administration will be increasingly realized.

Fourth, the regulation of the character of industry or of the affairs of individuals through penalty taxation assumes a degree of wisdom and foresight not likely to be possessed by those who design and administer such laws. American tariff history, for example, presents a considerable experience with this use, or misuse, of the taxing power. It would be difficult to establish that either industry or laborers, either producers or consumers had been benefited in the long run and on the whole from this prolonged experiment in taxation for regulatory purposes. The mercantile system was an analogous type of governmental control of industry and trade according to preconceived ideas of what was best for the country. Adam Smith's attack on this system is well known. His castigation of the

ruler who sought to order a nation's affairs by restrictions on trade and business is applicable to those who seek to accomplish this end through severe regulatory taxation.⁹

Severely regulatory taxation is part of the general idea of regimentation, of determining, on the basis of preconceived notions or on the basis of favoritism, the character of business or the line of conduct deemed to be good for the people, and of keeping everyone in the established channels by heavy taxes on variations and departures.

The English writer quoted above evidently has a fixed idea as to what is the social advantage. He would check harmful and useless luxuries, of which tobacco and alcohol are evidently illustrative. He would use taxation to stimulate production, or to avoid checking it. Implicit in this proposal, and as its logical conclusion pushed thus far, is the idea that it would be proper to tax tobacco culture out of existence in order to provide more land for wheat culture, even if the relative prices of tobacco and wheat did not effect such a substitution of use; and he would do this because of some curious preconception of where the social advantage lies. If relative price levels will not eventually stimulate or check production in the proper directions, it is assumed that some governmental agency will be possessed of sufficiently superior knowledge and wisdom to achieve, through regulatory taxation, what ordinary economic forces and motives will not do.

A distinction must be recognized between the kind and the purpose of the regulation that may be undertaken under the police power and that which is sought through taxation for social ends. The state has recognized authority, under the police power, to regulate business and the conduct of individuals in the interests of health, safety and morals, and it has power to punish violations by means of fines. Article VIII of the Bill of Rights provides, however, that excessive fines shall not be imposed, nor shall cruel and unusual punishments be inflicted. There is no constitutional protection against excessive penalty taxation, however, which may explain the preference for this method.

Evidently, if penalty taxation is to be used to keep people or business within determined bounds, the rights of individuals and minorities are in serious jeopardy. In Russia the analogous process of social regimentation is called *liquidation*, while in Germany it was identified by the grandiloquent term *race purification*. These extreme instances of minority oppression and extermination may seem altogether remote and unlikely

⁹ When the sovereign refrains from this attempted regulation he is "...completely discharged from a duty, in the attempting to perform which he must always be exposed to innumerable delusions, and for the proper performance of which no human wisdom or knowledge could ever be sufficient; the duty of superintending the industry of private people, and of directing it towards the employments most suitable to the interest of the society." *The Wealth of Nations*, Cannan Edition (1904), Vol. II, p. 184. (Italics supplied.)

here. On the contrary, they are not far away, when discrimination becomes the keynote of taxation, as it must when regulation rather than revenue is the objective. Any foolish purpose that may be dictated by whim, prejudice, or fixed obsession can be promoted, once it is granted that the taxing power may be used without regard to how the people ought to contribute to the support of government.

The most comprehensive non-fiscal objective of all is the so-called redistribution of wealth and income. It is to be accomplished by drastic progressive taxation levied on large incomes and large estates. The expression is a misleading catch-phrase intended to foment class hatred and class prejudice. A more correct term would be the destruction of wealth and income, for that, rather than any effective redistribution, will be the final result.

Such taxation will produce substantial revenue for a time, as an incident of the breaking-up process. Few are so stupid as to suppose that they will receive directly a share of the wealth and income expropriated. Only through a lavish program of public spending upon purposes designed to benefit the masses is there any prospect that they may gain, even indirectly, from the policy.

The combination of high income and estate taxes is perfect for the destructive process. Large incomes are derived principally from property rather than personal effort. A dispersal of the large estates through severe taxation therefore eliminates both the estate and the income from the category of bigness. Meanwhile, high income taxes would make certain that no more large estates were to be created through the investment of income. Eventually there could be no more accumulations such as have been seen heretofore.

But bigness is always a relative matter. In view of the fact that the political leaders of a democratic state would virtually never have the courage to declare that the destruction caused by such taxation had gone far enough, there would be no stopping place short of complete equalization. Any use of progression tends to impair the nation's capital fund. The effect of drastic progression is to consume this capital rapidly. If the process is to be in any sense a "redistribution," the government must spend for such purposes as will raise the real income of the masses, but this will not make good the capital loss. If the government uses the funds taken from private investors to create government-owned productive capital, it is merely transferring the capital from private to public ownership, and this is socialism. It is not even redistribution, for the masses would not benefit unless the government should prove capable of managing productive capital more efficiently than its private owners had been able to do.

Considering the political aspects of a program of redistribution through taxation, it is far more likely to be destructive than conservative.

Such destruction is a case of eating the seed corn. It will enable an administration to provide "bread and circuses" during the process but it will terminate in a rice-bowl living standard for all.¹⁰

¹⁰ Cf. H. L. Lutz, "Are Taxes for Revenue Obsolete?" *The Tax Review*, Vol. VII, No. 4, April, 1946.

CHAPTER XVIII

Means of Escape from Taxation

THE TITLE of this chapter requires explanation, which is promptly given in order to avoid all suspicion of being in league with those who are seeking ways of evading their proper share of the public burden. In discussing the means of escape from taxation there is no intention of rendering aid and comfort to the tax-dodgers. The object is, rather, to consider some of the ways in which escape from taxation does occur, as a natural, and in some cases, an inevitable feature of the operation of a tax system. It is a fact that taxes do not always stay where they are put. In defining the terms *direct* and *indirect*, it was pointed out that an indirect tax is paid by one set of persons and ordinarily transferred, or shifted, to another set. While tax shifting is perhaps the most important means of escaping taxation, there are other ways which deserve notice.¹

THE PROCESS OF TAX EVASION

The escape from taxation may occur either in such manner as to result in no revenue being received by the government, or in such manner that the tax is actually paid, but is passed on to others. If no tax is actually paid, it is a case of tax evasion, which may be legitimate or illegitimate. Illegal tax evasion means tax-dodging, through smuggling, the return of an inaccurate statement of one's property or income, and in various other ways. It is unnecessary to develop this phase of the subject further.

Legal evasion of taxes. But tax evasion may occur in ways that are perfectly legitimate. It may be that a certain tax is so high as to cause possible consumers or users to refrain from consuming or using the thing taxed. No tax is paid, and these persons may be said to have evaded the tax. Tariff duties are sometimes so high as to prevent all importation. Naturally, under such conditions the tax produces no revenue. The legislative intent may have been complete exclusion, in which event the escape

¹E. R. A. Seligman, *The Shifting and Incidence of Taxation*, 4th ed., Ch. I. Professor Seligman has explored this field, and especially the shifting and incidence of taxation, more thoroughly than any other American student. The author's indebtedness to him in this chapter will be apparent to all who are familiar with his investigation.

from the tax must be regarded as intentional, or it may be that this result was not intended. Tax laws frequently contain provisions under which it is possible for taxpayers to reduce, or even to escape, tax liability by meeting particular requirements of the law.² The United States Cotton Futures Act imposes a tax on all cotton futures transactions that are not carried out in a prescribed manner. During the Civil War a tax of two cents was imposed on all checks drawn for twenty dollars and over. A person who chose to arrange all payments by checks written for sums below the minimum to which the tax applied could lawfully evade this tax. The federal income tax permits the deduction of losses on the sale of securities from the gains realized on the sale of other securities. The treatises on corporations and corporation laws compare in some detail the provisions for the taxation of corporations in different states, and the balance of these advantages frequently determines the choice of a corporate home. It is entirely lawful for a person of means to establish his legal residence with a view to the method used in different states for the taxation of income or intangible property. It is unnecessary to multiply further the instances of legitimate tax evasion which are open to all who feel the need of taking advantage of them.

Escape from taxation may occur under certain circumstances, as has been said, although the tax is paid. Here the tax is not evaded, but is paid and then passed on or disposed of in some way by the person who pays it. That is, it is paid by one person, but its burden is made to fall on some other person or group of persons, to whom it is transferred. This general process of transferring tax burdens is called shifting, while the settlement of the burden on the ultimate tax-bearer is spoken of as the incidence of the tax.

THEORIES OF TAX SHIFTING

The fact that taxes may, under certain conditions, be shifted is one of the characteristics of taxation that has long been familiar to students and observers of tax systems, and has engaged their speculative interest more, perhaps, than any other aspect of the subject. A wide range of theories has been formulated to explain this phenomenon. It is unnecessary to review here all of these theories.³ Among the lot, two general tendencies stand out as most worthy of special mention, in part because each contains an element of truth, and in part because they will represent the extremes to which this kind of theorizing has been carried.

The concentration theory. The first may be characterized as the concentration theory, according to which any tax tends to gravitate or to concentrate upon a certain class of taxpayers, regardless of the original

² J. H. Sears, *Minimizing Taxes* (1922).

³ See the elaborate classification and analysis of these theories in Seligman, *op. cit.*, Part I.

point of levy. There was no general agreement as to which class was thus favored, but the choice usually fell on the landowner. There were probably more advocates of this view than of any other, and the reasoning by which such a remarkable conclusion was reached was, in substance, as follows: Wages are at the subsistence level, and any tax imposed on laborers or on wages must be passed back to the employers of labor in higher wages. Taxes on capital or on the profits of capital will drive capital out of industry, a result which must be taken to indicate a belief that the capitalist was getting simply a subsistence return also. Taxes on commodities will be the equivalent of taxes on laborers and on capitalists, and hence such impositions must result in higher wages or greater profits, else they cannot be borne. The upshot of it all was that the landowning class was proved to be the only one in the community which was receiving a clear surplus income, from which taxes could be paid without the necessity of shifting them to someone else. In the hands of the physiocrats, this doctrine became the basis of their proposal for the *impôt unique*, the one tax, to be levied on land.

The diffusion theory. Another theory of tax shifting, which may be called the diffusion theory, went to the opposite extreme, and postulated a general or universal diffusion of taxes throughout the community. A natural inference from this doctrine would be that the point of impact of any tax is immaterial, since an equalization of the strain through shifting is certain to occur. The diffusion was held to come about through the repeated processes of exchange, in which the buyers and sellers divided the tax in each transaction, until in time an equitable distribution had been effected. The principal test of equity in this case appears to have been universal distribution. Time was essential to this diffusion process, and in consequence old taxes, like old wine and old friends, were better than new ones. The diffusion of the old, established tax had already been accomplished, whereas new taxes were continually upsetting the general economic equilibrium in the process of spreading themselves throughout the community. Such a doctrine is a comfortable one for legislators and finance ministers, as it relieves them of all trouble of considering the relative advantages and disadvantages of different kinds of taxes.

In the extreme form in which they are here stated, both of these theories are obviously fallacious. Tax shifting is neither universal, nor toward any single economic class in the community. The element of truth in the concentration theories was that taxes on margins or necessary incomes tend to be shifted while taxes on surplus do not. Likewise, some diffusion of certain taxes undoubtedly does occur. For example, the retailer who must earn at least the normal interest on capital and, in addition, such profits as will induce him to continue in the business, must treat his taxes as a business expense, to be taken into account with the other

expenses in determining the mark-up on goods. Taxes on merchandise and on the building, which are paid by the merchant, tend to be diffused through the community in the prices that are established for commodities at retail. On the other hand, the merchant cannot so readily shift his entire personal income tax in the same way. The truth is that some taxes are shifted and some are not. The diffusion theory may be a comfortable one for finance ministers, but it is a dangerous one for the state that levies unfair or inequitable taxes and trusts blindly to shifting to equalize the burden and remedy the evils.

Shifting involves price manipulation. Since the process of shifting a tax from one person to another involves some kind of economic transaction between the two parties, it is apparent that the problem is one, at bottom, of exchange and price. Tax shifting requires that the person who originally pays the tax to the government shall be able to recoup himself by means of some kind of counterbalancing transaction. The direction in which a given tax will be shifted will depend somewhat upon the line of least resistance. The retail merchant, for example, may pass his taxes on merchandise forward to the consumers in higher prices, or back to the wholesalers or producers by forcing them to accept lower wholesale prices, or he may distribute it among the consumers, the producers, and possibly his clerical help by reducing wages or delaying increases. Corresponding to these possibilities are the terms forward, backward and diffused shifting.

Tax capitalization. Another method of transferring a tax is known as tax capitalization. The process of capitalization is the determination of the capital value of an annual amount by dividing this annual sum by a given rate per cent. Thus, the capital value of an annual income of \$50, at 5 per cent, is \$1,000. This is evidently the reverse of the more familiar fact that a capital of \$1,000, put at interest at 5 per cent, will return \$50 annual income. Capitalization is, indeed, the reverse of the process of interest computation.

Tax capitalization occurs when the amount of the annual tax is capitalized at some assumed rate per cent, and the capital value of the tax as thus obtained is deducted from the capital value of the object taxed. The effect of tax capitalization, when it is successfully accomplished, is to place the burden of the tax on the seller of the property subject to the tax. The whole procedure will be clearer, perhaps, from an illustration.

Suppose that a long-term bond for \$1,000 bearing interest at 5 per cent, is taxed annually at the rate of 1 per cent on the value. Deducting the annual tax of \$10 from the interest received, the holder of the bond would receive an annual net income of \$40. If an investor were considering the purchase of this bond under the conditions assumed, and if, in addition, it be assumed that he wishes to realize a yield of 5 per cent on his investment, clearly he could not afford to pay par for this particular

issue, since at that price his net return, after paying the annual tax, would mean only a 4 per cent yield. In order to secure a 5 per cent return, it would be necessary for him to reduce the price which he pays for the bond to a figure such that the net income obtained would represent the desired rate of income thereon. The annual tax on each \$1,000 bond is \$10, and by capitalizing this tax at 5 per cent a capital value of \$200 is obtained for the whole series of such annual taxes. Reducing the par value by this amount leaves \$800 as the price which the investor could afford to pay for the bond. In other words, the investor has capitalized the tax.

This hypothetical case has been stated quite baldly, with a view to explaining the process of tax transfer through tax capitalization. It omits various qualifications that would be included in a statement strictly in accord with the mathematics of investment. It is necessary, however, to mention certain conditions that must be observed if the principle is to find practical application as a means of transferring a tax to someone else. These are: (1) the tax must be an exclusive or unequal tax; (2) the commodity taxed must have a capital value, and must be capable of having an annual income or rental value.

In the first place, it is necessary for the tax to be exclusive or unequal. The buyer of bonds, it was assumed, could have put his money into other investment opportunities at a net return of 5 per cent. If there were a general tax of 1 per cent on the capital value of all forms of investment, no such option is open to him anywhere, and there is, in consequence, no possibility of capitalizing the tax on bonds. If, however, there were other investment opportunities which were less heavily taxed, that is, if the tax were unequal but not exclusive, he might be able to capitalize and deduct simply the amount by which the tax on bonds was in excess of the taxes on other forms of investment of the same desirability.

In the second place, the commodity in question must have a capital value, and must be capable of having an annual income or rental value. Long-term securities and land possess both of these qualifications. Some other forms of durable goods, like machinery, may also be in this class, but in most cases in which capital goods are being considered, the valuation will be affected by the cost of producing more machines or other units of the appropriate sort, and there is not the same possibility of influencing the selling price by capitalization of the income. These conditions really mean that the possibility of determining the capital value by capitalizing the annual income value is limited. The value of replaceable capital goods is not determined wholly in this way, but in part by their cost of reproduction. It seems unlikely, therefore, that many instances of tax capitalization would be found in which such goods were the vehicle.

The essential fact about the process of tax capitalization, in the few instances in which it can occur, is that the burden of a whole series of

taxes is thrown, in one transaction, on the present owner of the wealth sold. The subsequent owner pays the annual taxes, but his basis of investment in the property is such that he enjoys the normal investment yield after the taxes are paid. Hence the tax is no burden to him.

Professor Seligman distinguished between tax capitalization and tax shifting on the ground that by the former process a whole series of taxes is transferred in one transaction, whereas by the latter the tax is passed on each time it is levied. In this anticipation or discount of future taxes he sees a method of escape from taxation so fundamentally different from escape through tax shifting as to warrant the statement that "if a tax is capitalized it cannot be shifted."

This seems to be an unnecessary distinction. As a matter of fact, the new owner is responsible to the government for the tax levied, but he does not feel its burden because he has transferred it, once for all, to the former owner at the time of purchasing the object on which the tax is imposed. So far as the process of capitalization is applicable, and it is obviously of rather limited application, the essential elements of shifting seem to be present in this as in other cases, for the tax is paid by one person and borne by another. This is what is meant by tax shifting. Tax capitalization may be regarded, therefore, as a method of shifting that is used in certain cases.

Qualifications of capitalization. Two qualifications should be noted respecting the statement that a capitalized tax is burdenless. One is that it applies, obviously, only to the known or definitely anticipated taxes of which account was taken in the capitalizing calculations. The future may bring still heavier taxation than was foreseen, and the unanticipated, hence uncapitalized increment is, of course, burdensome.

The second qualification is that the continued freedom from burden, after successful tax capitalization, is contingent upon the continued receipt from the property of the volume of income calculated upon at the time of purchase. A shrinkage of income produced by a depression or other causes defeats the purpose of tax capitalization and subjects the present owner to a tax burden.

For example, suppose an improved parcel of urban property is bringing a net income of \$6,000 before deducting the property taxes, and suppose, further, that the known taxes of this sort are \$2,000 annually. At 5 per cent, the property would be worth \$120,000 if there were no taxes, but the capitalized value of the annual tax is \$40,000, so it should sell for \$80,000, at which price the purchaser would enjoy the normal 5 per cent investment return after paying the tax.

But suppose that the environment deteriorates, or that many competing structures are built, or that a depression occurs, with the result that the owner's net income before paying the tax drops from \$6,000 to \$4,000 annually. Under such circumstances his shrewdness in buying the prop-

erty for \$80,000 is of no avail, for his net income after paying the tax is only \$2,000, which represents either $2\frac{1}{2}$ per cent on his investment, or a capital value shrinkage to \$40,000 on a 5 per cent yield basis. A capitalized tax is burdensome to the purchaser only so long as the conditions assumed in his capitalizing calculations do not turn against him.

CONDITIONS OF TAX SHIFTING

In the limited instances of tax capitalization, the purchaser evidently has a strategic advantage and is thereby able to force the tax burden upon the seller. In the other cases of tax shifting, the seller or present owner of goods or services must have some kind of advantage if he is to be able to shift the taxes that he pays. In general, therefore, the problem of tax shifting becomes a problem of the conditions under which the person paying a given tax can increase the price of his commodity, his capital, or his services. Unless it is possible to increase the price the tax cannot be shifted. In cases of backward or diffused shifting, the retailer, for example, may transfer the tax on merchandise to the wholesaler, or the manufacturer, or to his clerical force through lower wages. In any event, when this happens, it means that the bargaining position of the retailer is superior to that of the wholesaler, manufacturer, or clerk.

Tax shifting depends on price control. Under what conditions can individuals or groups of individuals increase or otherwise control their prices for materials, labor, or capital funds in order to pass a tax over to someone else? For an answer to this question it is necessary to turn to the theory of value and price, for such light as the economist may be able to throw on the conditions under which individuals or groups subject to a tax are able to influence the prices which they obtain for their commodities or their services, and so to shift taxes imposed on them. A statement of the theory of value cannot be undertaken here and it is necessary to assume that the reader has such knowledge of the subject as may be gained from any good work on the principles of economics. The present discussion must be confined to a brief application of value theory to the phenomenon of tax shifting. For this purpose the procedure of forward shifting is used, but the logic of backward or diffused shifting is similar, although the economic pressure is exerted in a different direction.

It must be noted at the outset that the transfer of a tax from one person to another is not a voluntary or free will affair. That is, buyers do not go around offering higher prices from any philanthropic desire to assume taxes that have been imposed on sellers or producers. In order that a tax may be shifted, some form of economic compulsion is necessary; that is, the buyer must be made to pay more than before. Since buyers are free agents, and since there is nothing about the levy of a tax that would increase the utility of the object taxed, there is no way of directly

compelling the buyer to pay more. The compulsion must be exerted indirectly, by influencing the available supply of the object taxed. According to the general laws of value, the only way by which the price can be raised, assuming no change in the demand for the commodity and no variation in the value of money, is by decreasing the supply. The first step in the analysis of the mechanics of tax shifting, therefore, is to trace the general procedure of this influence upon supply.

Monopoly. If the commodity is controlled by a monopolist, he has direct control over supply and may vary it at will. But the curious thing about the taxation of a monopolist is that his disposition to shift the tax by varying either the supply or the price, will depend on the mode of taxation. The reason is that the relation between the quantity of a monopolized commodity that is offered for sale and the price that buyers will pay for the amount offered is established, under monopoly conditions, at such a point as will yield the maximum possible net revenue, or monopoly profit. If the price is increased, consumption is checked and profit is reduced below this maximum. If the supply is increased a similar result will be obtained, for the price must come down in order to induce consumption of the larger quantity, and again the net profit is below the maximum. Therefore, if a tax is imposed as a percentage on the monopolist's profit, he will not shift it, since no other combination of price and quantity sold will yield him as great a profit as the one established, and he will have a greater profit remaining after paying the tax, by leaving the market situation undisturbed. For the same reason a lump sum tax on monopoly profit would not be shifted. A tax based on the volume produced or on the gross sales may result in a reduction of output and an advance of price, since the monopolist thus cuts down the amount of tax, and he may succeed in passing all of it on to the consumers.

Competition. It is clear, therefore, that the question of tax shifting is as much, or even more, a matter of competition as of monopoly. Under competitive conditions no single producer or set of producers has effective control of the supply that is produced, nor of the price that will be obtained for it. Changes in the supply offered are made in response to changes in the demand. As the buyers evidence disposition to pay more for a given commodity, producers are correspondingly willing to provide more of it. The price that prevails in the market is established by the balancing or equilibrium between the marginal or least effective demand on the one side, and the cost of the most expensive part of the supply, on the other. Supply and demand are always in equilibrium, if prices are being established; but these prices will be high or low according to the relation between demand and supply. Now if something happens to cause an increase in the cost of production, it will be necessary for the producers ultimately to get a higher price or else to stand the loss. But a higher price cannot be asked without resulting in some check on con-

sumption. Yet the higher price must be asked, or the producers will lose, and in the end some of them will be forced out of the business. A tax on the capital used, the volume produced, the gross sales, or on any other factor common to all producers becomes a part of the expense of production, and is included in the factors which go to determine the cost of production of the marginal or most expensive portion of the supply. Thus the price is raised, a new equilibrium between demand and supply is established, and a somewhat smaller supply is able to find purchasers. Every instance of tax shifting involves some such mechanism of price change and adjustment as is here outlined, but some further qualifying conditions must be brought in before the account of the whole process is complete.

The laws of cost. In the first place it is necessary to consider the law of cost, as the economist calls it, that is operative in a given industry, before the effect of a tax imposed on the producers in that industry can be ascertained.⁴ The question here is not so much whether shifting will occur, but rather, the effect of this shifting upon the price under varying conditions of cost. Two important tendencies may be distinguished: one is the law of increasing cost, operative generally in the extractive industries, and the other is the law of decreasing cost, operative under certain conditions in manufacturing. If the cost of producing additional installments increases, due to permanent and irremovable differences in cost to the several producers, then the imposition of a tax will raise the marginal cost, but the new equilibrium price will not be higher than the old by the full amount of the tax, since the new margin of production cost is now somewhat lower than before.

One of two things must happen as the tax is imposed. Either the producers who were just on the margin before the tax is imposed are crowded out, since their cost plus the tax is greater than the new price will cover, or they must accept continued economic degradation and relapse into debt if they continue. In the long run the former must happen, but the process may require time, and as long as they continue to add their quota to the supply by selling at a loss, there is less tendency for the price to advance as the result of the tax. Seligman intimates that in some agricultural sections, for example the cotton belt, the difficulty of withdrawing is intensified by the unwillingness to sacrifice the capital that has been invested in the land in the way of improvements, the uncertainties of other occupations, ignorance, and other factors. The effect of a tax on an industry that is subject to the law of increasing cost will be to cause an increase of the price by something less than the amount of the tax, but the promptness and certainty with which this result is

⁴ For the elaboration and illustration of this analysis, the reader should turn to A. Marshall, *Principles of Economics*, (1910), pp. 480-483. See also H. G. Brown, *The Economics of Taxation* (1929).

attained will depend upon the celerity with which the supply is reduced through the failure or withdrawal of the marginal producers. In the long run this result is inevitable.

If the industry operates under the law of decreasing cost, the effect of a tax will be to cause an advance of the price by an amount somewhat greater than the tax. Here price is determined, as before, by the equilibrium of cost and demand, but in this case the determining influence on the cost side is not the least efficient producer's cost, but that of the most capable and efficient producer. The tax becomes an element of cost, as before, but its addition to the price causes such reduction of the quantity demanded, and therefore of the quantity produced, that the customary economies of large-scale production, both internal and external, afford a lessened advantage, and marginal cost is higher than before.

Mobility of capital. It is evident that under either of these laws of cost, the ease and certainty of tax shifting will depend upon the degree to which the labor and capital employed are mobile, free to move from one industry to another. The withdrawal of the marginal producers is one way of affecting the supply, and hence the price. If one industry is heavily taxed, and if the capital employed therein is easily withdrawn, there will be greater certainty of shifting. If the capital is largely fixed, hence immobile, withdrawal will be slower and shifting correspondingly retarded. No industry enjoys complete mobility, and none suffers from complete immobility, of either labor or capital. Circumstances differ, and the ease with which transfer of capital may be effected depends on the nature of the industry and other factors in the general economic environment. In the long run an industry that is subjected to specially heavy taxes will receive no new supplies of capital, and a gradual withdrawal will occur through the process of depreciation, until the output declines sufficiently to cause the price to advance and the burden to be equalized.

The reference to the mobility of capital as a factor in shifting implies that there are other investment opportunities in which this capital would not be subjected to equally heavy taxation, or that capital, if heavily taxed, will be converted into consumers' goods. This suggests another condition, which is that the tax must be an unequal or an exclusive tax, if shifting is to occur. Unless the producer can withdraw to some other industry, or to some other place, in which he will have no tax, or less taxes, there will be no disposition, from the standpoint of taxation, for him to move, and consequently the effect of his withdrawal on the supply will be lacking. The more general the tax, therefore, the less opportunity there is for such migration of capital to occur, and the less likelihood there is of the tax being passed along through an advance in price. A general tax on capital may become so heavy as to discourage further saving and investment, and thus ultimately to reduce the supply of capital. Production will then decline, until the advance of price brings about a

transfer of the tax. Heavy taxes on income, or on estates, by checking the growth of capital, may produce this result.

Elasticity of demand. Thus far the problem of tax shifting has been discussed primarily from the standpoint of the producer. The nature of the demand, especially with regard to the degree of elasticity, must also be considered. Elasticity of demand means the degree to which the amount demanded will be affected by changes in the price. Elasticity is always a relative matter. The general principle is that the more inelastic the demand is for a commodity, the more certainly and completely can the tax on this commodity be shifted. If consumers will buy practically as much of it at a higher price as they will buy at a lower price, then the increase in price will not check consumption, and tax shifting is more easily accomplished. On the other hand, if slight changes in price cause great fluctuations in demand, the dealer will naturally hesitate long before risking the severe shrinkage in his sales which even a moderate price advance would be sure to produce.

Demand is relatively inelastic in the case of certain necessities, such as salt, and of some luxuries. The demand for comforts and conveniences is much more elastic, and taxes on these goods are less easily shifted.

Economic margins and surpluses. There is a certain element of truth in the concentration theories, which is that taxes on economic margins tend to be shifted while taxes on economic surpluses are not shifted. In the case of production at increasing cost which was discussed above, there would be no need of shifting the tax if some way could be devised to levy it simply on those producers who were most favorably situated. Such a way can, indeed, be found, in the case of land, by imposing the tax on economic rent. This return is a surplus, determined by the difference in advantage which any given land affords over and above the cost of production on marginal or no-rent land. The landlord cannot and does not determine the amount of this surplus, hence can do nothing about shifting a tax imposed on it. On the other hand, a tax imposed on marginal conditions, or on margins where the entire return to land, labor or capital is required to requite the effort put forth, involves the submersion of some economic factor below the level of normal or necessary return, and hence must eventually be shifted, if that land, or labor, or capital, is to continue its service in production.

In this connection Seligman suggests that a progressive tax may have less effect on prices than that produced by a proportional tax. The latter would affect all proportionately and might bear heavily enough on the marginal producers to force some of them out. But the progressive tax would tend to fall most heavily on the most prosperous, and might pass entirely by the marginal producer. In so far, therefore, as the progressive tax tends to fall on surpluses rather than on margins, it may lead to less shifting than would a proportional tax.

Strategic advantage. Finally, the factor of strategic advantage must be mentioned. This is primarily a matter of tactics and mechanics, rather than of the laws of value. Since shifting always means an effort, possibly a struggle, between two parties, there is a certain tactical advantage in having the tax originally imposed on the other party. The burden of shifting is then on him, and one may count frequently on a certain amount of economic friction, inertia or unwillingness to disturb established conditions or procedure to operate against shifting. The tax tends to stay where it is put, unless steps are deliberately taken to roll off the load. Economic principles are seldom found operating with clean-cut, mathematical accuracy and exactness under dynamic social and economic conditions, and cases may be found in which a tax is not wholly shifted, even though theoretical considerations indicate that it should be.

Economic friction and rigidity are more important than is ordinarily assumed, and their weight compels the observation that tax shifting is far more difficult and complicated than is commonly supposed. There is a powerful and entirely natural reluctance to take losses quickly. Even insolvency does not always mean withdrawal from production, for the receiver appointed by the court as trustee for the creditors usually continues to operate the business. Since he need not pay interest or dividends, the receiver is a more dangerous competitor than the former management had been. The burden of all losses as well as of taxes for the particular concern falls on the owners, and possibly in part on the creditors, but continued operation prevents that readjustment of supply for the industry as a whole which is essential for tax shifting through price advance. In general, owing to the numerous and difficult complications involved, the case is far stronger against tax shifting than for it.

THE INCIDENCE OF PARTICULAR TAXES

After this necessarily brief outline of the conditions that enter into the determination of the escape from taxation through shifting, some illustrative cases will be considered with a view to observing the more concrete application of these principles.

The first of these illustrative types of tax shifting and incidence is the tax on lands and buildings. Such a tax is levied, in the United States, as a part of a more comprehensive property tax. It is necessary to separate this tax into two parts, one of which is the tax levied on the land, and the other is the part levied on the building. This separation is required on account of the difference in the incidence of the two taxes. For administrative reasons buildings and land are usually assessed separately under the property tax.

Taxes on land. First, who bears that part of the tax which is imposed on the land? The general tendency is for this tax to fall on the owner of

the land. If the land is leased, the owner would willingly enough pass the tax along to the tenant by exacting a higher rent. But on the assumption that the latter is already paying the full economic rent of the land, the fact that there are taxes to be borne does not enable him to pay more rent. The conditions which determine the rental value of a piece of land are determined entirely independently of the taxes which may be imposed. If the landlord is exacting the full rental value of the land he is already getting from the tenant all that the latter is able to pay and continue to use the property in a business way. It may happen, due to the ignorance, indifference or indulgence of the landlord, that the terms of the lease call for a contract rent that is less than the true economic rent. The increase of the tax burden may, under these circumstances, stimulate the owner to a more careful consideration of rental terms when renewals come around. After all possible adjustments of this sort have been made, however, the burden of the tax will ultimately rest on the owner.

The tax on the land may be collected from the occupier, as is the practice in England, or the tenant may contract to assume the taxes as is often done in land leases in the United States. In these cases the tenant estimates as carefully as possible the probable taxes that he will be called upon to pay during the life of the lease, and figures his total rental payments accordingly. Whether the tax is imposed directly on the owner or is collected from the occupier of rented property, that part of the tax which falls on the land is ultimately borne by the owner.

This general principle applies both to urban and to agricultural lands. There is greater uncertainty, in the latter instance, as to the degree to which the return is a true economic rent, or is simply a return on the capital invested in the land, through maintenance of fertility, irrigation, drainage, erosion control, and other forms of capital investment to sustain productivity. In proportion as the current product becomes dependent upon the maintenance of this capital investment in the land, the return loses its character as a form of true economic rent and becomes interest on capital. Since the farmer is able to vary the expenditure that he makes on the land, by reason of which its productivity is sustained and enhanced, according to the clear return that he gets on his capital investment, it follows that such part of the agricultural land tax as falls on this necessary return will be eventually shifted to the consumer in higher prices. In so far as there is an element of economic rent in the return from agricultural land, the tax will fall on the owner and will not be shifted.

As between the present owner and the future purchaser of a piece of land there is a tendency for the existing taxes to be borne by the former, through the process of capitalization or absorption of the tax in the lower capital value which the land will command. Reference to the earlier summary of the principle of capitalization will reveal the fact that the realization of this process evidently depends on circumstances that are

not always present, and that its occurrence is therefore somewhat uncertain. Thus the condition of exclusiveness is not present while the land tax is part of a general property tax, although it may appear if the exemption, or even the general escape, of personal property should convert the property tax substantially into a land tax. The reduction of rates on certain classes of property under a system of classified property taxes provides the condition of an unequal tax, and admits the possibility of capitalizing the excess of one rate of taxation over another.

Another condition is that the series of future tax payments must be capable of being discounted, a process which requires a known or certain rate. But the property tax rate from year to year is often uncertain, consequently the present capital value of all future payments may be indeterminable. As a result, there is some doubt as to the certainty with which tax capitalization operates, and therefore some doubt whether the entire burden falls on the present or the future owner. This much is evident, although it does not answer the question very satisfactorily. To the extent that the future tax burden may be forecast with sufficient accuracy to permit discounting to occur, the subsequent purchaser will tend to allow for it in the price he pays for the land, providing, however, that he has other investment openings which are less heavily taxed.

A neutralizing tendency may sometimes enter, in the shape of an anticipation of future increases of land value in the prices that prevail at a given time. This tendency would manifest itself concretely in the establishment of a level of current prices for certain tracts or parcels of land that would mean a lower return on these investments than that to be had on investments in general. After a period of years the growing income from the land is expected to bring the yield up to a level that will represent a fair, even a handsome, return on the investment. Land speculators not only figure on such sources of gain in buying land; they base their selling appeal on the same line of argument when the time comes to unload their holdings. Such gains may be wholly or in part illusory. Buying land for the rise is not a certain way to wealth, despite spectacular exceptions. The general conclusion must be, therefore, that the new purchaser does not acquire the land, in this country, wholly free of the existing tax burden. At best, he may resort to capitalization of the excess of land taxes over the average burden on capital investments, and under some circumstances the counter tendency to anticipate future gains may result in offsetting, or more than offsetting, all advantage from such procedure.

Taxes on buildings. A different situation is presented by the tax on buildings. A building is a form of durable capital investment, and the taxes on this investment tend to be borne by the occupier or user of the structure. If the owner is also the occupier, there is clearly no alternative but for him to bear the tax unless he is engaged in some business that will

afford him opportunity for shifting. If the building is occupied by tenants, the long-run tendency will be for the tax to fall on them, on the principle that the supply of buildings will be so regulated by the flow of capital into this form of wealth that the normal clear return will be realized. If the taxes are levied on the owner, and conditions are such that shifting to the tenants is impossible, the immediate result is to reduce the return on this form of investment below the normal or necessary yield. A diversion of funds ensues, the supply of buildings declines, and house rentals must eventually advance sufficiently to restore the net income to its necessary or expected level.

All of this is, however, a slow process which will work itself out only over a long period of time. Capital invested in buildings cannot be immediately transferred. Once it has been tied up in this permanent form the owner's return must be governed by the state of demand and supply. The temporary or intermediate incidence of the tax on buildings will depend, therefore, on the current relation between the demand for buildings and the supply of them. In the case of a prosperous, growing community, whose population is expanding rapidly, the demand for building accommodations tends to outrun the supply of such facilities. This welling tide of demand is in evidence in any community that is experiencing rapid growth, whether from local factors, or as a manifestation of the general upward swing of the business cycle. Under such conditions building owners are able to obtain rentals that cover taxes and upkeep expenses, in addition to a satisfactory return on the capital. If the growth has been very rapid or very unexpected, those owners who are able quickly to readjust their rentals will reap, temporarily, a return materially above the normal. Such a situation stimulates building, and the later stages of the prosperity phase of the business cycle usually find a building boom under way unless it is held in check by other factors, as is the case under the controls that are imposed during a war.

On the other hand, if the supply of building accommodations exceeds the demand, the competition of owners to find tenants will result in a downward revision of rentals, until the owners may not be securing anything like a fair return on their investment. Taxes on buildings cannot be shifted to tenants under these conditions, but must remain definitely on the owners.

Both of these conditions are temporary. In the long run, the supply of building accommodations will be increased if the return from such investments is unduly large, and the equilibrium price that will be paid for this form of durable capital goods will tend to be such that investors will earn a normal or reasonable return, taking into account the hazards of the undertaking. Likewise, in the declining community, construction will be greatly slackened, houses will fall into disrepair, into decrepitude and eventually into ruin. Finally, this process of decay will bring a down-

ward adjustment of supply to demand which, as in the opposite circumstances, will tend in the long run to yield the investor in building property the normal return clear of the taxes.

In the case of buildings used for business purposes a further process of shifting becomes probable. The tenant, who is conducting the business, must obtain at least the normal return on the capital which he is using on this site. As building taxes become heavier, they bulk larger in the merchant's expenses, and must be met by corresponding upward revision of prices. High building taxes tend, therefore, toward higher prices for merchandise, although high taxes on land cannot have this effect.

There is a widespread misunderstanding regarding tax shifting which must be cleared up. It is frequently assumed that because the owner of property or the seller of goods or services pays the taxes out of gross rentals or gross receipts, the tenants or consumers who provide these receipts are bearing the burden. The taxes on buildings, on merchandise, on railroads, and the like, are naïvely assumed to be shifted as a matter of course, simply because they constitute a charge against the gross receipts and are paid out of the money received from customers.

It is true that the funds for tax payment are provided from the gross rentals of property, or the gross sales of merchandise, or the gross revenues from freight and passenger traffic, in the case of railroads. But this does not mean, necessarily, that the burden of the tax falls on the tenant, the consumer, or the shipper, respectively. The crucial test of tax shifting involves the rate of investment return, and no tax on property or business can be said to be shifted unless the actual taxpayer is enjoying a normal and reasonable rate of return on the capital investment *after* paying the tax. If he is not, it means that he is unable to charge enough for the goods or services sold to cover both taxes and interest as elements of expense. Only when this is possible can it be said that the tax on the property or business has been shifted.

Taxes on personal property. Another illustrative type of tax, the incidence of which will be examined briefly, is that part of the general property tax which is levied on personal property. There are many forms of such property, which range all the way from the personal and household possessions of the taxpayer to the machinery, merchandise and livestock used in business or farming. The problem of incidence turns largely on the question whether this wealth is used for personal purposes only, or whether it is used as capital in further production. Taxes on articles of personal use obviously are not shifted, since there is no price transaction subsequent to the imposition of the tax that would enable the taxpayer to shift it. In this class belong clothing, furniture, books, pictures, jewelry—the whole varied mass of personal property which is often so indifferently assessed for taxation. The second class of personalty includes those concrete forms of wealth which are used in production—capital

goods—and, under the general property tax, various kinds of intangible property rights and other evidences of wealth.

So far as the tangible personal property used in further production is concerned, the possibility of shifting will depend on the operation of the general factors governing incidence which have been discussed above. Back of these factors, as the motive power which induces the tendency toward shifting, is the desire of the owners of capital to secure the best possible return, which means, when viewed universally, the normal return. If taxes on certain kinds of property, or in certain jurisdictions, are such as to interfere with the realization of this desire, capital owners will transfer investments, they will migrate to other places, and, as a last resort, they will consume rather than save. If the long-run conditions are such, therefore, as to discourage or prevent shifting, a decline or withdrawal of capital investment may be expected. This will happen only in the long run, however. When an individual buys livestock, or merchandise or machinery, the prospects of shifting the current taxes are not always certain. The stock feeder who has bought steers for fattening, and who is unable to avoid assessment by judicious shipment from state to state, or from pen to stockyard, expects to recover his tax in the price realized. But when a corn-fed steer is ready for market the only thing to do is to sell. The price realized will depend on the market, and over this the individual seller has no control. High or low taxes have no effect on the price, or on the feeder's gross profits. Year by year the return realized must cover taxes, or the enterprise will languish; but the shifting of any given year's taxes is entirely problematical. It depends on the price that is realized, which goes back to the fundamental equilibrium of supply and demand for the commodity.

The case is similar with merchandise and machinery. The owner of free capital funds may control the direction of his investment, while it is yet unmade, and to this extent he is exercising some control over the incidence of his tax burden. Once he has committed himself, the possibility of tax shifting is, in some degree and it may be, wholly, removed from his control to the broader field in which prices are determined. Year by year the merchant and the manufacturer must recover their taxes by passing them on to the consumer, or the inevitable withdrawal of capital will occur. Any given year's taxes may fall on them, however, by reason of their inability to sell that year's stock or output at prices that will permit inclusion of taxes. The general course of the business cycle has an important bearing on this matter also. When wholesalers and retailers started unloading in the summer and autumn of 1929, for example, there was little consideration given to the taxes assessed against the merchandise that was sacrificed.

It appears, therefore, that in the long run, taxes on capital goods tend to be included as business expenses in the accounts of those who are using,

making or handling such goods, and tend ultimately to be passed on to the consumers in the way of higher prices. The ease and certainty with which this happens will depend upon various circumstances that have been set forth above in the discussion of the principles of shifting. The ultimate adjustments in accordance with these principles are not always easily nor quickly made, and the temporary incidence of the burden may therefore be quite different. This distinction between the immediate and the ultimate incidence of the taxes on various forms of wealth is doubtless summed up under the general heading of economic friction, which, as Professor Edgeworth observed, covers everything of practical importance.

Taxes on income. The shifting of a tax on income is difficult and the traditional view has been that such a tax is practically never shifted. In the case of the individual, the principal recourse, after a tax has been imposed on his income, is to demand a corresponding advance of salary, wage, commission or other personal service remuneration. Since there is nothing in the fact that an income tax has been imposed which would alter the value of one's personal services, the chances would appear to be against wage or salary increases on that account. If the tax is heavy enough to cut deeply into the accustomed standard of living, the employer may accede to the demand for increases, or he may be forced to do so by an aggressive labor organization.

Assuming that the former scale of wage and salary payments were a fair measure of the value of the services rendered, the increases made as an offset against the workers' income taxes would be, to that extent, an overpayment for personal services. Employers would carry the new wage costs into their expense accounts, and the effect would be to reduce profits unless it were possible to sustain the former profit level by getting more from consumers. But, as already shown, it is difficult to get a higher price while maintaining the same volume of sales. Some part of the supply must be withdrawn before this adjustment can be made. A factor contributing to this result would be present if wage advances to recompense workers for income tax were general, since the marginal firms would also be affected. This addition to their costs would tend to drive them the more rapidly from the field, thereby opening the way for the price adjustments necessary for shifting the higher wage costs to consumers.

The case of public employees appears to be an exception, mainly for the reason that politicians are always especially sensitive to the reactions of those on the public payrolls. After the Supreme Court had ruled that state and local employees should pay federal income tax, the New York legislature refused to reduce salaries of state employees, as part of a general economy drive, on the ground that the federal income tax to which these employees had recently become subject constituted a salary cut. The committee report indicated that reductions would have been

recommended had the court decided otherwise. This leaves a strong inference that the incidence of the federal tax was really upon the taxpayers of New York State.⁵ In 1940 the Secretary of the Treasury advised against reducing federal salaries because they were subject to income tax.⁶

The tax on personal income from property is even less likely to be shifted. Transfer of investments within the country is of no avail against the federal income tax, although this device does become important in considering the weight of state and local taxation. The average stockholder is unable to speed up the business of his company so as to secure greater returns, and he ordinarily has no control, as an individual, over its price and management policies. If the tax becomes too heavy he may decide to spend his capital, which would assure him of escape from the tax, as well as the complete loss of his income.

Taxes on corporation and other business incomes may lead to efforts at shifting, first, to the consumers by advancing prices, or second, to the employees in lowered wages or delayed wage advances, or finally, to the stockholders in reduced dividends. The question of price advances covers ground already traversed. Such factors as the elasticity of demand, the degree to which enlarged output will reduce costs, the relative position of the representative firm with respect to the margin of production, the necessity of holding laborers or stockholders in line by attempts at price advance rather than by wage or dividend cuts, and other similar questions enter. Efforts to secure higher prices will ordinarily be of small avail,

⁵ *Alternative State Budget for New York*, submitted by the Republican Conference, April 17, 1939. Published in the *New York Times*, April 18, 1939.

"Salary decreases There has been much public talk of general salary reductions. At no time did we ever consider blanket salary reductions for all state employees. We did, however, give serious thought to making graduated salary reductions on all salaries over \$2,000.

"In view of the recent decision of the United States Supreme Court, which removed the arbitrary distinction heretofore existing between persons working for the State and those privately employed, in our opinion any salary reduction not only would be a tremendous burden, but also would have unfortunate social and economic effects.

"We are opposed, therefore, to salary decreases except as noted below. To prevent administrative officials from reducing the salaries of those not protected by specific statutes, we recommend that, except when salary reductions are specifically authorized by statute, the salary of no employee shall be reduced unless specifically authorized by the budget director."

[The exceptions relate to various salaries in the racing commission, state hospitals, park commissions, etc.].

⁶ *Hearings before the Senate Committee on Finance, on the revenue bill of 1940*, p. 2. Note the following

"I am also opposed to placing a disproportionate part of the cost of our national-defense program upon Federal employees by reducing their salaries. Along with the rest of the people of this country they will make an increased tax contribution in accordance with their ability to pay. The new taxes will apply equally to them as to other individuals."

however, and it must be concluded that a general tax on corporate or other business net incomes is not readily shifted. There is nothing inherent in the fact that a tax has been imposed on net income to give a business firm operating under competitive conditions any power over the price of its product that it did not otherwise possess. The mere imposition of a tax will not permit an automatic advance of price, unless its effect on marginal conditions of production is such as to cause a reduction in the supply of goods produced.

Illuminating data on this point are provided by the corporation income tax returns. The figures in Table XXXII are illustrative:

TABLE XXXII
GROSS INCOME REPORTED BY CORPORATIONS, 1935-1939 ¹
(BILLIONS OF DOLLARS)

<i>Year</i>	<i>With Net Income (1)</i>	<i>With No Net Income (2)</i>	<i>Total (3)</i>	<i>Percentage (2) of (3)</i>
1935	\$ 77.4	\$36.5	\$113.9	32.0
1936	104.8	27.5	132.3	20.8
1937	109.0	33.0	142.0	23.2
1938	80.1	39.9	120.0	33.3
1939	105.4	27.0	132.4	20.4

¹ Source: *Statistics of Income, Part 2, Preliminary, 1939, Table 3*

The period covered by the table was one of business ups and downs, and it purposely does not show the later years of steadily enlarging defense and war expenditures. Judging from the entire past record, of which only a portion is presented in the above tabulation, there will always be a significant volume of goods and services sold by business concerns which, at the moment, are not subject to the income tax and which, therefore, do not take this tax into account in their prices. It is hardly reasonable to suppose that total sales constituting from one-fifth of the total in some years to almost one-third in other years would not be a factor that would materially affect the prices that the profitable companies could obtain.

Since the corporate enterprise cannot ordinarily shift its tax on net income by advancing prices, the burden must eventually be distributed between the laborers and the stockholders. Comparative bargaining strength may determine the extent to which the former group can be forced to assume a share. If the tax is passed back to the stockholders by reducing dividends, the effect may be ultimately a loss of capital and credit standing culminating in failure. The elimination of the extra-marginal firm tends to ease up the pressure on the supply of the commodity, to facilitate price advances, and so to save the day, temporarily

at least, for the other concerns. In this way shifting may be brought about, but there is here, quite obviously, a chain of events over which the individual concern has no control.

The result may be different in the case of the public service enterprise, which is a regulated monopoly. The theory of rate regulation is that rates shall be adjusted at a level that will afford a reasonable return on the investment, and taxes on the business net income are generally allowed as an expense in computing this return. It is possible, therefore, that heavy taxes on public utility net income may lead to higher service rates.

Even so, the transfer of the burden of the business income tax to consumers is not automatic as rates are increased. The advance may check consumption and thus diminish both gross and net income. This outcome depends on the level of the rate zone. The demand for public utility services is reasonably inelastic within a certain zone, but above this zone a considerable elasticity would be found. If the rates had previously been low enough to permit of an increase without checking consumption, the tax can be shifted; but if the rate level had already reached the upper limits of the zone of inelasticity of demand, a further rise would reduce consumption and thus possibly defeat the intention.

Sales taxes. The general practice under sales tax laws is to require the seller to include the tax as a separate, distinctly additional amount to be collected from the purchaser at the time of sale. The dealer pays the tax to the government, but he collects directly and openly from the consumer and it is generally supposed that the burden of this tax falls on the latter.

This assumption is probably correct on the whole. Sales tax laws are uniformly strict in requiring direct and open collection, which prevents some merchants from seeking advantage through open absorption of the tax. The rates are moderate and collection is by piecemeal. The law cannot control the price policy of merchants, and there is no way of ascertaining the extent to which silent absorption goes on through price adjustment. The most that can be said, in the present state of knowledge concerning the effects of a sales tax, is that direct collection is *prima facie*, but not necessarily conclusive evidence that the consumer bears the burden of this tax in all cases.

Processing taxes. A peculiar situation arose in connection with the taxes collected from the processors of certain agricultural products under the first Agricultural Adjustment Act. The tax became effective in 1934, and was thrown out by the Supreme Court on January 6, 1936. During 1935 substantial amounts of the tax were not actually collected, for two reasons: (1) processors often lacked cash to pay the tax due and were granted extensions; and (2) injunctions in lower courts against enforcement of the tax pointed the way to the eventual downfall of the act.

Consequently, when the final decision came, the situation was as follows: First, processors were in position to file claims for the refund of all taxes paid under the act, according to federal legislation of long standing, which provided that any one who had paid a tax imposed by an unconstitutional act would be entitled to a refund of the payment upon presentation of proof that he had actually paid it. Second, the accounting records of processors revealed that certain amounts of tax levied prior to January 6, 1936, had not been paid, and that in some cases the cash for such payment had been impounded pending the final decision of the court.

Under the long-established procedure relative to refund claims, the Treasury faced the obligation to repay an enormous sum.⁷ Since all of the processing tax collections had been paid out as agricultural subsidies, repayment in full would have been extremely embarrassing, both financially and politically. To avoid these adverse results, the refund procedure was changed in the case of the processing taxes and for these taxes only. In addition to the simple proof that the claimant had actually paid the tax illegally collected, he was required to furnish further proof that he had borne the burden of that tax and had not shifted it.⁸ That part of the processing tax which should have been paid with respect to the commodities processed prior to January 6, 1936, but which was not paid for the reasons noted above, was declared to constitute "unjust enrichment" to the extent that the processors had actually shifted its burden to others.⁹

The basic assumption underlying the provisions of Titles III and VII of the Revenue Act of 1936 was that the processors had shifted the whole of the processing taxes. Accordingly, they were presumed to be entitled to no refund of the tax actually collected, and the portion of the tax not collected was regarded as windfall income, to be subjected to a special tax of 80 per cent. The law authorized processors, however, to introduce evidence to show that they had not shifted the tax, or that they had shifted only a part of it.¹⁰

Obviously, complicated and difficult issues are involved. Congress was rushing in where economic experts hesitate to tread, in legislating upon so obscure a subject as tax shifting and incidence. According to conven-

⁷ The total of processing taxes collected was \$959,968,573.

⁸ This change was effected by Title VII of the Revenue Act of 1936.

⁹ Cf. Title III of the Revenue Act of 1936.

¹⁰ The Department of Agriculture obligingly came to the rescue with a document purporting to show how the various processors had shifted their respective taxes. The conclusions expressed in this document have been widely accepted. Cf. *An Analysis of the Effects of the Processing Taxes levied under the Agricultural Adjustment Act*. Prepared by the Bureau of Agricultural Economics, United States Department of Agriculture, published by the United States Treasury Department, Washington, 1937. The present writer has studied in detail only the hog processing taxes, but his results do not support at all the findings of the Bureau of Agricultural Economics with respect to this tax. These results are contained in an unpublished memorandum.

tional tax theory, an attempt by processors to raise prices by the amount of the tax, and on account of the tax, would not succeed until some producers—or processors—had been crowded out by the higher cost of production, including the tax, which they were required to pay in the first instance. But the period during which the tax was in effect was one in which the government was curtailing agricultural production, destroying surpluses of some products, and incurring large deficits in an effort to raise both prices and consumer incomes. To what extent the price changes of the processed commodities were caused by these policies, and to what extent they indicated tax shifting, no one can tell with accuracy. It was not correct to assume, however, that the tax was the sole factor.

The Revenue Act of 1936 was loaded against the processor, in that the statutory test of shifting was different in the case of claims for refunds than in the case of so-called "unjust enrichment." The test of shifting was to be a comparison of the processor's average margin for the tax period with his average margin for the base period. But the base period to be used in the comparison, in the case of refunds, was to be the six months following termination of the tax and the twenty-four months prior to its inception (twelve months in the case of tobacco). For determining whether that part of the tax due but not actually turned over to the Treasury, the alleged unjust enrichment, the base period was to be the six years prior to the tax.¹¹

This is an extraordinary arrangement. Beyond question, the processors followed the same course throughout, whatever that might have been. They did not pursue one policy while tax payments were actually being made, and another while extensions were being granted or money was being impounded under court orders. What, then, was the reason for the very different bases provided as tests of tax shifting?

The explanation appears to be as follows. No chances were taken that large refunds would be payable, so a base period was chosen which included two of the worst depression years and only six months of reasonable prosperity. A comparison of margins received during the recovery years 1934 and 1935 with the average margin of the bottom of the depression would make a watertight case in favor of the presumption of tax shifting, and hence would defeat the refund claims. On the other hand, with respect to the taxes due but not paid, a more liberal construction of the conditions of shifting could be afforded, so the six years preceding the tax were used. On this basis, if the comparison of margins showed that the tax had not been shifted, no unjust enrichment tax would be payable. This would merely diminish revenue receipts. No money would have to be paid out in refunds.

¹¹ Margin was defined as sales volume less cost, divided by the number of units processed. A margin was to be computed for each month and averaged for the period.

From the published data relative to processing tax collections it is possible to form an estimate of the effects of the two bases established by the act of 1936 for the determination of final processing tax liability.

TABLE XXXIII
COLLECTIONS AND REFUNDS OF PROCESSING TAXES, AND COLLECTIONS OF UNJUST
ENRICHMENT TAX *

<i>Fiscal Year</i>	<i>Collections</i>	<i>Processing Taxes Refunds</i>	<i>Unjust Enrichment Tax</i>
1934	\$371,432,886	\$1,194,639	.....
1935	526,222,358	31,208,208	.....
1936	62,323,329	10,081,744	. ....
1937	.. ....	6,515,773	\$6,073,351
1938	.. ....	10,232,689	6,216,736
1939	.. ....	12,004,543	6,683,335
1940	.....	11,771,638	8,536,178
1941	.. ....	8,115,716	9,095,562
1942	.. ....	21,437,069	4,401,768
1943	.. ....	7,500,365	1,808,294
1944	.. ....	421,377	433,724
<i>Totals</i>	<i>\$959,978,573</i>	<i>\$120,483,761</i>	<i>\$43,248,948</i>

* Compiled from the *Annual Reports of the Secretary of the Treasury*

It will be noted that of the total refunds of the processing taxes, more than \$42,000,000 were made before the end of the fiscal year 1936, that is, without reference to the tests established by the act of 1936. The remainder of the refunds was spread out over a period as a result of the delays incident to the preparation of the cases for claims and the slow-moving review process.

The amount of processing tax liability established during the part of the fiscal year 1936 in which the tax was operative, but which was not paid because of extensions granted and court restraining orders, is not available. Assuming, however, that for the full year 1936 the tax would have equalled the return for 1935, then the yield for the half-year of operation (July 1, 1935 to January 6, 1936) would have been some \$263,000,000 in round figures. Deducting the actual tax payments for 1936 would leave approximately \$200,000,000. This is indicative of the amount of windfall, or unjust enrichment, on the assumption that the processing taxes computed but not paid during 1935 were shifted up to January 6, 1936.

The refunds of processing taxes allowed after 1936, on the basis of the tests of shifting of taxes already paid which were provided by the act of 1936, totalled \$78,000,000 in round figures, or about 8 per cent of the total collections. Had the same test been provided for the determination and recovery of unjust enrichment, the amount recoverable would have

been some \$184,000,000. That is, about \$16,000,000 would have been re-funded. The Ways and Means Committee reported an estimated yield of \$100,000,000 from this tax. Since the tax rate was 80 per cent, the estimate of the total windfall was evidently \$125,000,000.¹²

According to the record, total collections of unjust enrichment tax through 1944 were \$43,248,948, indicating total unjust enrichment found to be subject to tax of some \$54,000,000, or only 27 per cent of the probable amount of processing tax deemed to have been withheld from the Treasury, though shifted to others. The marked difference in the basis of the shifting test, as compared with that used in the case of the taxes paid, no doubt accounts for the discrepancy. In any event, the processors fared much better with respect to retaining their impounded tax funds than with respect to recovery of the taxes already paid. Such was, of course, the intent of the law.

The experiment was quite inconclusive, so far as establishing the actual degree to which this kind of tax is shifted. Its principal lesson should be a warning against the incorporation into statutes of theories regarding which empirical proof is so difficult and uncertain as is the case with the shifting and incidence of taxation.

The excess profits tax. Thus far in our fiscal experience, a tax on excess profits has been restricted to war financing. It is generally agreed that such a tax has no proper place in a peace economy. As a temporary, emergency tax, there is little occasion to consider its incidence. However, it has been the subject of some discussion.¹³

The correct determination of the amount of excess profit earned by any concern, even during a war, is difficult, and any statutory definition is necessarily arbitrary. On one side, the hazards involved in providing large capital for war production are considerable, since the duration of the war is unpredictable and the specialized plant and equipment may have no value for peace production. But on the other hand, there is an assured market, while the war lasts and possibly for some time thereafter, for all that can be produced. One consideration points to liberality in the construction of the excess profits concept, while the other points to a strict interpretation. In any case, what must be dealt with is a volume of profit which is determined by artificial rules rather than by the operation of unhampered economic forces, to be in excess of some normal level.

The ordinary logic of tax shifting hardly applies to such a case, since that logic involves the conditions under which shifting may occur in the course of open market transactions. That is, a tax is said to be shifted when the taxpayer recovers from someone else, in concurrent or sub-

¹² H.R. 2475, 74th Congress, 2nd Session, April 12, 1936.

¹³ For example, Marion Hamilton Gillim, *The Incidence of Excess Profits Taxation*, Columbia University Studies in History, Economics, and Public Law, No. 514, New York, 1945.

sequent market transactions, the amount of the tax paid. Here, however, we have to deal with a tax on an arbitrarily determined amount of so-called excess profit which emerges under highly unusual and abnormal market conditions. Consideration of these conditions makes it far from clear that there is any propriety in discussing the subject.

When a nation engages in extensive war preparation, or is plunged into war, two conditions are usually responsible for the appearance of large profits. One is resort to loan financing, often on a substantial scale, the other is feverish haste in letting war contracts. The manner of financing quickly provides ample funds, and may promote careless application of them under the spur of the war urgency. There is an immense need for munitions of every sort. Industries must convert their facilities to the production of these goods. Few of them have previously engaged in such production, and many things which no one has ever made before must be turned out in quantity. In view of the urgency and the lack of experience in producing the desired goods, there is small wonder that the original contract terms will be out of line with the production costs that will be established as managers and workers gain experience in the new fields. Consequently, because neither contracting party could correctly anticipate the course of production costs, and because one, at least, of these parties felt justified in subordinating the matter of cost to other considerations, large profits in war contracts were virtually inevitable.

To be sure, the inflationary conditions of war lead to increased profits elsewhere than in war contracts, although the great bulk probably arose from this source. An excess profits tax of general application was therefore more appropriate than one limited to war profits in any narrow sense.

The real problem would appear to be the question of the incidence of the war costs. A tax on excess profits, during a war, is merely a device for recovering a portion of the large gains which arise from the errors and miscalculations in the case of the war contracts, and a portion of the unusual gains of other businesses which are attributable to the volume of trade that is incident to the war activity and inflation. The widening margin between contract terms and actual costs as the latter were reduced is the source of the large profit, some part of which is, by statutory definition, declared to be an excess profit and subject to recovery through a heavy rate of tax. The important question of burden relates to the war cost, which, in an economic sense falls on the generation which experiences the war, and in a financial sense falls on the people of present and future generations who must pay the taxes for the war and the debt. By recovering a part of the contract terms of the war cost through an excess profits tax, these financial burdens of the war period and later are to that extent lightened. It is pointless to talk about whether or not this tax is currently shifted. The law permitted a company to earn a normal or

standard profit before becoming subject to excess profits tax. If its earnings exceeded the standard allowance, the excess of earnings was deemed to be excess profit. It would be naive to speak of the war contractors shifting the excess profits tax by charging the government enough to enable them to pay the tax on their excess profits.

Another device for the correction of the results of the contract procedure is renegotiation of the war contracts. This procedure was introduced in 1943. In essence, it involved a redetermination of the prices and other terms set in the original contract, in the light of the production cost experience. To the extent that the payments were readjusted in line with actual cost experience, recoveries were made under past contracts and new terms were set for future contracts. The effect of renegotiation was to diminish the basis of excess profits, and it thus operated as a kind of alternative to the tax. Both devices served as correctives of the original contract procedure, and it would be as proper to speak of the shifting of renegotiation as of the shifting of the excess profits tax.

CHAPTER XIX

Tax Systems and Tax Administration

THE DISCUSSION of taxation to this point has dealt with matters which might appropriately be characterized as the "principles" of taxation. In the succeeding chapters devoted to the subject, various specific forms of taxation are considered. Before proceeding with these detailed forms or methods of taxation, however, it seems proper to present some brief comments on tax systems and tax administration. While these subjects are in a sense unrelated, they are nevertheless akin in that they both underlie the material of the ensuing discussion, and it is therefore appropriate to present them together in this chapter.

SYSTEMS OF TAXATION

In the absolute sense there is no such thing as a "system of taxation," meaning thereby that there are certain taxes which belong together and must be used together as parts or elements of a "system." Any group of taxes which happen to be used by a taxing jurisdiction is spoken of as the "tax system" of that jurisdiction. The selection of the taxes which the people of a state or of a nation shall pay is a matter of public policy regarding which the citizens themselves should enjoy wide latitude. No tax is perfect and none is wholly bad, as a means of raising revenue. Any sort of compulsion or dictation in this matter, such as might be attempted by a group of states against another state, or by the federal government against the states, would be an intolerable interference with the prerogatives of local citizenship.

Development of tax systems. The taxing methods used by any state, and the particular principles to which it may seek to give expression, or its tax system in this sense, will be determined partly by the current popular attitude toward these various principles, and partly by the prevailing economic, sectional and political influences. Professor Dewey summarizes the differences in colonial taxation as follows: ¹

In the democratic communities of New England, we find the primitive poll tax, a tax on the gross produce of the land, which was finally expanded into the general property tax; to these was then added a faculty tax (*i.e.*, an

¹ D. R. Dewey, *Financial History of the United States* (1922), p. 10.

income tax). In the Southern colonies with their class supremacy the land tax was naturally unpopular among the landholders and taxes laid upon slaves found little favor because they also reached only the influential and ruling part of the community. Consequently taxation was mainly indirect through import and export duties. In the middle colonies conditions cannot be so easily classified either as democratic or aristocratic; the trading class with Dutch methods dominated and this naturally favored the excise system which had been developed in Holland.

The federal constitution gave future tax developments in the United States impetus in certain directions, through its restrictions and reservations. Thus, export duties were forbidden, and the states were deprived of the privilege of levying duties on imports. The federal government was forbidden to use direct taxes, except as these were apportioned among the states according to population. Neither jurisdiction may tax the agencies and instrumentalities of the other. In consequence, the tax revenues of the federal government were provided, until the Civil War, largely from the customs duties on imports, with occasional resort to internal commodity or excise taxes. Commodity taxes, it should be noted, are available to both federal and state governments, although the early federal use of them, and the relatively low state revenue requirements during the nineteenth century, prevented any general state use of excise taxes. After the Civil War excise taxes became a permanent feature of federal taxation, although the customs continued to be the mainstay. To the states was left the taxation of property, inheritances, incomes (except for brief federal excursions into this field), business, and the forms of business organization such as the corporation.

The Sixteenth Amendment, approved in 1913, permitted federal taxation of incomes without the necessity of apportioning the tax according to population. With the entrance of the United States into the first World War, the federal tax program was greatly broadened. Heavy income and profits taxes, estate and gift taxes, and a great range of commodity taxes were employed. The main outlines of the federal tax program then adopted have since been retained, and the more recent pressure for revenue has led to rates exceeding those of the first World War period.

Federal and state tax conflicts. There is no clear demarcation between federal and state tax jurisdictions, except for the restrictions imposed by the federal constitution. The growing need for revenue has impelled state and federal authorities to reach out for all available tax resources. The situation has given rise to protests against joint federal and state taxation of the same classes of objects and to propaganda in favor of one solution or another.

The emphasis in these proposed solutions has necessarily been on some kind of deal with the federal government.² It has possession of certain

² Cf. *Report of the New York Tax Commission*, 1934, pp. 8-11.

taxes and is exploiting them so fully under heavy rates that the only hope of the states is to propose some acceptable basis of adjustment. The more important proposals to this end are the following: (1) an extension of the tax credit device now used for the estate tax; (2) federal administration of certain taxes, with distribution to the states of a part, or all, of the yield; (3) segregation of revenue sources by assigning some taxes for federal use and others for state use.³ None of these proposals is accompanied by emphasis on expenditure reduction, which is the one condition that might make any of them acceptable, or workable.

Tax credit. The tax credit means that if both state and federal governments are using the same tax, the amount collected by one government shall be allowed as a credit against the amount due to the other. It is generally assumed that the federal tax would be the heavier and that the state tax, or some proportion of it, would therefore be credited.

The supposed merit of this plan is that it enables the state to share in the tax, while it limits the burden on the taxpayer. Against this advantage must be offset certain objections:

First, the limitation of burden may be illusory, for the federal tax rates may be raised enough to provide substantial federal revenue after deducting the credit allowed to the state.

Second, the determination of the kind of tax to be allowed as a credit may involve friction. For example, many kinds of business taxes are used by the states. Which of these, if any, are to be allowed as credits against the federal tax on corporate incomes? Federal determination of the kind of tax that the states must use in order to apply the credit would result in federal regulation of the character of state taxation, a situation which could easily become intolerable.

Third, the states would be obliged to maintain a parallel and duplicating tax administration. This conflicts with another complaint about the existing situation, namely, that duplicate tax administration is an unnecessary expense. The burden of claiming and establishing a right to the tax credit would be on the taxpayer, hence his vexation would not be diminished.

Federal administration and revenue sharing. A second series of proposals involve complete surrender of the administration of certain taxes to the federal government, with an arrangement for sharing the yield in some manner with the states. Various sharing devices are possible. A fixed proportion of the yield could be set aside, leaving the residuum for federal use. Or the rate of tax provided by state law could be incorporated into the federal return and collected as a supplemental tax for the states.

The proposal to centralize tax administration under federal control

³ Cf. the discussion of these alternatives by R. M. Haig, "The Coördination of Federal and State Tax Systems," in *Proceedings of the National Tax Association*, 1932, pp. 220-232.

evidently assumes that federal tax administration is superior to that of the states. This assumption needs to be examined.

The federal government would not be hindered by the commerce clause, and there would be some gain through the elimination of the specific costs of the state operation of the particular taxes surrendered. Aside from these sources of advantage, it is not so clear how definitely superior in tax administration the federal government is. The record in income taxation is not impressive, despite the large yield. The administrative interpretation of the federal law has been irregular and vacillating; the taxpayers have been overwhelmed by a flood of changing rules and regulations; and the reviewing agencies are swamped.⁴ There is no tax roll of income taxpayers. Assessment of income and collection of the tax are done by the same person, an arrangement that renders careful audit of receipts more difficult. The showing is largely due to the weight of the higher rates and the severe penalties, but these are not evidences of good administration.

It is reasonable, and tends to serve the ends of justice, to increase the severity of enforcement measures in proportion as the rate of the tax obligation is lightened. The states have found it possible to use much stricter measures in enforcing a three mill tax on intangible property than could be justified when the rate was thirty or forty mills, for such rates were generally recognized to be unreasonable. The federal policy is the reverse, for it penalizes heavily transgressions which the law itself provides strong incentive for committing. Since those with the largest incomes and estates are subjected to greatest temptation, it is easy to gain popular support for severe penalties by characterizing these evaders as enemies of society. Governments need to be extremely careful about such things, although the shoe is never put on the other foot. If the taxpayer who yields to temptation is to be jailed for attempting to defraud the government, the official who defrauds the taxpayer under the patronage system should no less deserve the same treatment. Curiously enough, standards for expenditure of public funds are never as high as they are for tax payment.

Some of the states are no doubt doing as good a job of income tax administration as the federal government; certainly a number of them could do it as well. Naturally all of them are hampered by virtually complete federal absorption of the revenue possibilities under it. The movement to extend the credit arrangement is not so defensible on the basis of superior federal administrative capacity as it is on the ground that the

⁴ Cf. the criticisms of the review procedure by R. Magill in his paper, "Federal Tax Administration," in *Annals of the American Academy of Political and Social Science*, January, 1936, pp. 179-188. It is significant that these comments should be possible after more than twenty years of operation, and after nearly twelve years of experience with the board of tax appeals, now the tax court.

states' only chance to realize important revenue from it is to share, by a tax credit device, in what the federal government now levies.

All questions of relative administrative capacity aside, it must be clear that any scheme whereby the federal government acts as tax collecting agency for the states merely solves certain difficulties by creating others. State competition to determine tax jurisdiction is thereby ended; but state competition to share in the revenue has only begun. Even if the federal government were acting simply as an administrative agent, the problem of returning the tax according to its origin in the several states would involve arbitrary decisions; and any other method of apportionment would expose them to far more "log-rolling" than has been produced by the struggle over the commerce clause.

Segregation of revenue sources. This plan would assign some taxes to the federal government, others to the states. On the basis of the earlier experiences of the states in attempting to segregate the sources of state and local revenue, the outlook for satisfactory results would not be bright.⁵ This is the more likely in view of the fact that there can be no such degree of centralized control in the relations between the federal government and the states as is possible in the case of a state and its local subdivisions.

While the present need for revenue continues, there is no prospect that any substantial degree of revenue separation can be inaugurated. The Committee on Postwar Tax Policy proposed that federal relinquishment of the death and gift taxes, the gasoline tax, and the motor vehicle use tax, to the states would be a helpful first step in the direction of restoring historic sources of state revenue to the states.⁶ It was also proposed that the states give up the tobacco tax to the federal government. Despite the extent to which the sales tax is now used by the states, this group of experts was unwilling to recommend its definite assignment to the states. Federal need may become so great, if the expenditures are not kept within reasonable bounds, as to warrant federal resort to a sales tax rather than to an unbalanced budget.

TAX ADMINISTRATION

No tax or system of taxes is self-operative; therefore, the character and quality of the administration of taxes becomes important if the exercise of the taxing power is to produce public revenue. The subject includes, first, the steps or stages involved in the application of any tax, and second, the tax administrative organization.

⁵ Cf. C. J. Bullock, discussion in *Proceedings of National Tax Association*, 1907, pp. 586-590.

⁶ The Committee on Postwar Tax Policy, *A Tax Program for a Solvent America*, Ch. 14.

Steps involved in the exercise of the taxing power. There are certain clearly defined processes occurring in a regular sequence, that are required in the levy and collection of any tax. In some cases each process is distinct from the others, while in other cases some of them may be telescoped together in such manner that they are not easily distinguished and recognized. Some steps are established by statutory, or even by constitutional provisions, others are determined by the officers responsible for tax administration or by the taxpayer himself. The several stages or processes, in the order of their occurrence, are the following.

Determination of the nature of the tax base. The tax base, that is, the objects or classes of objects to be taxed, and the manner in which they are to be taxed, is determined by the law providing for the tax. The base may be property, or a single commodity such as gasoline or tobacco, or certain kinds of goods imported from abroad. The tax may be based on the value of the goods, or on some specific measure of quantity such as the gallon or the pound. Despite the care that may be used in drafting tax laws, the tax administrator is frequently called upon to decide, in borderline cases, whether an object is taxable or not, and such disputes may even be carried to the courts.

*Assessment.*⁷ In taxation, assessment means determination of the amount of the tax base. The character of this base, that is the kind of object to be taxed, is fixed under the preceding step. Assessment is the fixing of the amount of the base to be taxed. For example, the tax law requires that real property be taxed on its value. Assessment, in this case, is the determination of the value of separate tracts or parcels of real property. The manner or method of assessment depends on the nature of the tax. If it is imposed on the value, assessment involves appraisal or determination of the proper value, whether of property or of imports. If the tax is imposed according to weight, number or quantity, assessment means the appropriate kind of checking, by weighing, counting or measuring, designed to establish the amount of the tax base.

Assessment may require the services of trained officials, as in the case of the property tax and the duties on imports, or it may be done by the taxpayer himself as under the income tax. The income tax law determines the character of the tax base, which is net income, and it requires each individual to determine and report, that is, to assess, the amount of his net income. This report is subject to verification when necessary, by trained examiners, but the original assessment of income is made by the taxpayer.

It is desirable, whenever the character of the tax and the manner of its operation will permit, to set up an assessment roll upon the completion of the assessment. This roll consists of a list of the taxpayers

⁷ See H. L. Lutz, article on "Assessment" in *Cyclopedia of the Social Sciences*, Vol. 2, pp. 276-278.

subject to the tax, with a statement opposite the name of each describing the property or other tax base assessed to him, and the amount of the assessment. The property tax provides the best opportunity for preparing an adequate assessment roll, and something of the sort is generally found. Such a roll could and should be set up for the income tax, but this is not done except by the states of New Mexico and Wisconsin.⁸

In the case of the property tax, the assessment roll is prepared from the field blotter or field note book which the assessor carries with him on his round of visits. The essential factor in recording the assessment of real property, that is, land and its improvements, is a careful, exact description of the property rather than the name of the owner, for such property should be assessed *in rem*. This means objectively, without regard to the fact of ownership. If the owner is known, it is a convenience in making out the tax bill, but the owner's name is not essential to a correct or accurate assessment. In fact, it is conducive to better assessment if the owner is not known to the assessor.

Levy of the tax. The next step in logical sequence is the levy of the tax, which means the formal order for tax payment upon the assessed base, at certain rates or in specified amount. The procedure of tax levy varies with different taxes. In some types the rate or rates of tax, and the formal levy, or order that the tax be paid at these rates, are set out in the tax law. Thus, the gasoline tax is levied in the law at so many cents per gallon, the tax on cigarettes at so many dollars per thousand, the income tax at certain graduated rates according to the amount of the income. On the other hand, the property tax may be levied at a fixed rate set by the law, or at rates that are determined after the city, county and school district budgets have been approved, providing for a certain volume of expenditure to be met by the taxes on property. In such cases a tax ordinance or resolution is voted by the budget-making body, either as part of the budget or separately, as a formal levy of the tax.

The term *assessment* is frequently used both in its proper sense, and improperly as the equivalent of levy. Thus, the imposition of the tax is often spoken of as an *assessment*. It should be clear from the distinctions brought out here that the tax is not assessed, but levied, and that assessment means the determination of the amount of the tax base by appraisal or other appropriate means. This confusion is often found in tax laws, where it sometimes seriously distorts the meaning.⁹

Determination of the tax due. The computation of the tax due, once the assessment and the rates of levy are fixed, is largely a routine clerical

⁸ Cf. C. C. Plehn, "An Assessment Roll for the Income Tax," in *Bulletin of the National Tax Association*, Vol. V, April, 1920, pp. 213-220.

⁹ Cf. *Revised Statistics of Maine*, 1930, Chap. 12, Section 73. The typical income tax law begins thus: "There shall be assessed, levied, collected and paid a tax upon the net income . . . etc." Such a sentence is inaccurate and pompously redundant. The income is assessed, while the tax is levied. Obviously, if it is collected, it is paid.

process, involving only simple arithmetic. It is done by an official in the case of the property tax, by the taxpayer under the income tax, and by the vendor under the retail sales tax.

Upon the determination of the tax due, a tax roll should be prepared in every instance in which such procedure is practicable. Like the assessment roll, the tax roll is a list of taxpayers, with a statement opposite each name of the total assessment and the amount of tax due on this assessment. The assessment roll will show the full details of the assessment in each case, such as, in the case of the property tax, the amount of land of each class as provided in the land classification scheme used, the unit and total values of the amount in each class, the kinds of personal property and the values thereof. The tax roll carries simply the aggregate assessment for each person, the tax rate, and the amount of tax due. It should also show the distribution of this tax to the state, city or town, county and school district. The tax roll is an indispensable feature of good tax administration, for it becomes the official record and evidence of the assessment and the tax levy, yet it is seldom found except in connection with the property tax.

The tax roll should be made in duplicate, one copy going to the tax collector and one to the auditor as a means of checking and controlling the collector's payments to the treasurer. The practice of making duplicate copies has led to a quite general use of the term *duplicate* or *tax duplicate* as a synonym of the assessment roll or the tax roll. In some New England states, the property assessment roll is called the "Grand List."

Assessment and tax rolls are most feasible in the case of taxes collected regularly on an annual basis from substantially the same group of taxpayers. They could be set up, however, for the indirect taxes that are collected from manufacturers or wholesale distributors, such as the taxes on tobacco, gasoline and liquors. Naturally no tax roll of the ultimate bearers of indirect taxes would be possible.

Review. Since the processes of tax administration involve at so many points the exercise of human judgment and discretion, every good tax law will contain provisions for a review of these decisions, whether made by officials or by the taxpayer. The privilege of review may be invoked either by the officials or by the taxpayer at any stage in the taxing procedure, but it is most likely to be exercised in connection with the assessment, for it is at this point that the principal errors of judgment are likely to occur. In the case of returns made by the taxpayer, that is, self-assessment, all returns are examined for clerical accuracy and for any superficial evidence of incorrectness. All large returns are subject to verification by reference to the taxpayer's records. But review of an income tax return, in the sense implied here, goes further than mere verification. It means carrying the issue between the assessor and the taxpayer to some other authority. Under the federal procedure a board of income tax appeals

has been established for such cases. This body is now the United States Tax Court.

Two methods have been followed in establishing a review procedure. One is administrative, or quasi-judicial, the other is judicial. That is, the appeal may go to some higher administrative authority, as the state tax commission, or it may go to the courts. In hearing appeals, the commission is functioning in a quasi-judicial capacity, but it is not limited to the methods customarily observed by the courts in seeking the facts. If it is a question of property values, for example, the commission may go to the locality involved, make personal examination of the facts, draw upon the services of other assessors or upon its accumulation of statistical data, and thus arrive at a decision.

In general, administrative review of the factual issues of taxation is preferable to judicial review, although the strictly legal issues must go to the courts for determination. The tax administrator is engaged continuously with the concrete aspects of taxation, and is better qualified to ascertain the facts than are the judges who deal with such matters only in cases brought before them. Further, the administrative review can be conducted in a less formal, and therefore less expensive way than the judicial review. Individuals are not permitted to state their own case before a court, but must engage attorneys authorized to practice law. Enlightened tax commissions encourage informal appeal procedure and permit property owners to appear in person, thereby lessening the expense of review proceedings. Under any review procedure, the basic requirement of due process, namely notice to the parties interested and opportunity for a hearing, must be observed.

In the case of the property tax there has developed a routine and automatic review procedure designed to promote the equality of assessments. The assessors' results in property assessment go before a local board of review, acting either for the tax district or the county, and the adjustment made by these local boards may be automatically subject to further review and adjustment by a state board of equalization if the state levies a tax on property for state use, or if the state valuation is used, as in Wisconsin, in the computation of an average rate of property taxation. Reviews of this routine nature are really part of the assessment process and are regarded as essential to its completion. The review privilege which is discussed here exists apart from the regular review of all assessments, and may include an appeal from the decisions of the assessor or from those of the reviewing board.¹⁰

Collection. The goal of the whole taxing process is the provision of revenues. All that has preceded, in the routine of tax administration, is of little avail if collection of the tax is not made. Yet, despite its impor-

¹⁰ In Massachusetts and New Jersey a board of tax appeals has been established, to function in a quasi-judicial capacity as a state agency.

tance, the arrangements for efficient collection have sometimes been more neglected than any other aspect of tax administration. Thus, the administrative changes of the past forty years, looking toward the improvement of the property tax, have dealt almost wholly with assessment, and scarcely at all with collection.

Since tax collection involves directly the taking of private property for a public purpose, the collection process requires some kind of authoritative sanction, though this formality is not always observed. In some states, collectors of the property tax receive, with the tax roll, a warrant directing and authorizing them to collect the taxes shown to have been duly levied. This formal authorization to collect the taxes set out in a tax roll is seldom provided in the case of other taxes, for the reason that the tax roll itself is so rarely prepared in other cases. Tax collectors should always be required to give bond for efficient and faithful performance, as should all other officers having responsibility for the handling or custody of public funds. In Massachusetts the tax commissioner passes on the bonds tendered by town collectors, and is able thus to exercise effective supervision over the personnel of this service.

Tax collection may be handled by the officer who makes the assessment, or by some one connected with another division of the government. The local property tax collector is always a different person from the assessor; but various state taxes may be collected by the assessing agency. In the federal organization, the heads of the two revenue divisions are designated as Commissioner of Internal Revenue and Director of Customs, respectively. These officers are of course responsible for the assessment of all objects on which taxes are collected by them.

It is desirable to observe as fully as possible Adam Smith's third canon of taxation, that of convenience to the taxpayer, in collecting taxes. This is accomplished in various ways, such as accepting personal checks, establishing suitable districts for collection purposes, and providing for installment payments. After reasonable requirements of this sort have been met, however, it is essential that the collector should proceed firmly and impartially.¹¹ Much complaint is often directed against the tax collectors, who have apparently been held in low popular esteem since biblical times, but this attitude is not justified. The time for objecting to the weight of taxation has long since passed when the collector presents the tax bill. Often those who are most active in urging liberal public expenditures are most strenuous in their opposition to prompt enforcement of the tax obligation.

Penalties. Any law that is to produce results through proper observance must provide adequate penalties, and tax laws are no exception. Tax

¹¹ The treasurer of Hamilton County, Ohio, attributed the unusual collection results achieved there during the depression years to the absolute impartiality shown in making collections. Cf. *Proceedings of the National Tax Association*, 1932, pp. 61-69.

penalties fall into two general classes—those imposed for delay and inadvertent negligence in filing returns or making payments, and those for deliberate attempts to evade the tax obligation. The usual penalty for delay, without evidence of wilful intention to evade, is the addition of interest at a substantial rate on the amount of tax overdue. The taxpayer's negligence has deprived the government of funds to which it was lawfully entitled, after the tax levy, and penalty interest, at rates exceeding the ordinary legal maximum for private loans, is an appropriate corrective measure. The presence of the intent to evade is more serious, and in addition to penalty interest in such cases, a substantial fine, or a penalty addition to the tax, or even imprisonment, is found in tax laws. Provision for prison sentence for serious evasion is more frequently found in income tax laws than any other, yet a person who fails to disclose his entire net income is not defrauding the government in a more serious way than the one who makes no protest when the assessor of property assesses his property at a valuation far below the actual market value. Such errors are simply charged up to the incompetence of the assessor.

As a final penalty for non-payment of taxes, tax laws commonly provide that the property against which the tax lien stands may be seized and sold at public sale. This procedure may be effective for a moderate degree of tax delinquency, but recent experiences have demonstrated that it is a useless gesture in the event of wholesale refusal or failure to pay taxes.

The tax administrative organization. The second aspect of tax administration is the organization for handling such matters. The federal government and each of the states maintain their own organization for such purposes. The federal tax organization is under the Treasury Department. It consists of two main divisions, one in charge of the customs and the other in charge of internal taxes. Some of the special taxes imposed for agricultural relief during the depression were determined by the Department of Agriculture, or by special agencies.

Federal tax administration. The two divisions of federal taxation differ in many ways in organization and procedure. The Secretary of the Treasury is legally the head of the customs, and he exercises his control through a division of customs, headed by a Director of Customs. The internal revenue system is headed by a Commissioner of Internal Revenue, appointed by the President. Both the Director of the Customs and the Commissioner of Internal Revenue are under the immediate direction of the Assistant Secretary of the Treasury in charge of revenues. Other important differences between the two revenue units are thus summarized by L. F. Schmekebieer:¹²

¹² L. F. Schmekebieer, *The Customs Service* (1924), p. 80. Institute for Government Research, Service Monographs of the United States Government, No. 33. This monograph was written before the board of tax appeals was established.

While the Bureau of Internal Revenue has a large number of employees in Washington the force of the Customs Service at the seat of government is very small, consisting of only about fifty persons. In the Bureau of Internal Revenue both the administrative and investigating units report to the Commissioner of Internal Revenue, while in the Customs Service the administrative and investigating units (the Division of Customs and the Special Agency Service) are coordinate branches reporting to the Assistant Secretary in Charge of Revenues. The decision of the Commissioner of Internal Revenue is final on all questions of fact and law, and any taxpayer objecting to his interpretation of the law must bring suit in a federal court to recover the amount paid, while in the Customs Service the decision of the collector on questions relating to duties, whether made by him originally or upon direction of the Secretary of the Treasury, is subject to appeal to a special court known as the Board of General Appraisers.... A further appeal may be made to the Court of Customs Appeals, and in certain cases to the Supreme Court. In cases arising under the navigation laws, however, the appeal lies from the collector to the Commissioner of Navigation or to the Secretary of Commerce, and then to the United States courts.

For each branch of the federal revenue collection an extensive organization has been built up. Presentation of details here would require more space than can be used, and the reader must be referred to the special publications dealing with the subject.¹³

State tax administration. In the states, the existing tax organization is the product of a long evolution. The moving force in its development has been the struggle with the problems presented by the property tax, which has been, throughout the national history, the most important source of state and local revenue. The early tax organization of the older states was always local, and the changes that have occurred have been in the direction of an increasing degree of state administration, and of state supervision over local administration.

Local boards of review. The first step, historically, in the efforts to correct and overcome the defects of the original local assessment of property, was the creation of local boards of review. In some states township boards of review were set up, in others a county board. In still other cases both township and county boards were provided. In the latter event the assessors' returns of individual assessments were reviewed first by the town boards, and the town and city aggregates were again reviewed and corrected by the county boards, which usually had no authority to make further changes in the individual returns. Their review was confined, in this event, simply to adjustments among the several taxing districts, which meant only a rough smoothing out of the district totals, even if the county boards went at their work in the proper spirit.

¹³ Cf. Schmekebie, *op. cit.*; also, L. F. Schmekebie and F. A. X. Eble, *The Bureau of Internal Revenue* (1923). Institute for Government Research, Service Monographs of the United States Government, No. 25. Also the chapter on tax administration in *A Tax Program for a Solvent America*, by The Committee on Postwar Tax Policy.

As a matter of fact, all of the local boards were too frequently lacking in the proper authority, and consequently in the proper interest in their work, to achieve significant results. If the tax rates for county and state purposes were heavy, the county equalization became simply a process of juggling with totals, with a view to evading as much as possible of this general tax burden, or of passing it over to the tax districts not represented on the county board. The log-rolling tactics which later marked the work of so many state boards of equalization were zealously applied. It was futile to attempt a serious equalization, since the real source of inequalities, the local assessments of individuals, was beyond their reach. The methods of review, and the means available to the local boards for determining the real facts at issue, were so deficient as to preclude accuracy from the outset. These boards therefore resigned themselves the more readily to the familiar tactics and practices of evasion and undervaluation.

The state equalization. As the pressure became greater for the further escape from the rising burden of the general property tax, still another stage of the equalization process was introduced in the hope of checking the tendencies that were under way. This was the state equalization, which began in many states during the middle of the nineteenth century. In a few states, as in Connecticut, New Hampshire and Ohio, the state equalization dates to about 1820, but the early Ohio equalization dealt with farm lands only, and in the other two states the general property tax defects were already quite apparent.

The earlier state board of equalization was usually composed of state officials, who served in an ex officio capacity as an equalizing board. Ohio and Illinois elected their boards at decennial and quadrennial intervals, respectively. Each made but one equalization of real estate during its term, but the Illinois board met annually for an extremely indifferent adjustment of personal property assessments and the valuation of certain corporations.

The older state boards of equalization had no means of dealing adequately with the problem of equalizing property assessments over the state. State officials acting in an ex officio capacity had little enough incentive to study this complicated subject, in addition to the duties of their respective offices. In no case was there any pretense at the collection of data on the basis of which an equalization might have been more carefully made, and the information available to these boards was supplied chiefly by the delegations sent to the state house from the counties to protest against the valuations locally established. This meant, in reality, a demonstration of the strength of the local political forces, and the resulting state equalization was more than likely to be a log-rolling process.

State boards of assessment. The growth of the railroads, and later of other classes of public utility corporations, presented problems of assess-

ment which were recognized to be beyond the jurisdiction and the capacity of local assessors. Between 1860 and 1890 state boards of assessment appeared in a number of states for the purpose of making these assessments. The composition of the boards varied. In some states, the state board of equalization assessed the corporations, in others another group of state officials was constituted a state board of assessment, while in a few cases the board was composed of a group of citizens appointed by the governor. While the earlier state assessment of the large utility corporations was undoubtedly superior to that made by the local assessors, there was still much room for improvement, owing to the lack of facilities and the absence of a suitable technical viewpoint.

The state tax commission. A final administrative development has been the establishment of the state tax commission. The first of these tax commissions was created in Indiana in 1891. Today they are found in more than forty states. Their advent marks the final attempt to bolster up the general property tax, a task to which they were destined to prove unequal. From the standpoint of tax administration, the state tax commission is a significant development, for the experience that has been accumulated since the tax commissions were established will be very helpful in the operation of state and local taxation, regardless of the kinds of taxes used.

Three principal functions were given to the typical tax commission. First, they were put in charge of the state equalization of local assessments. Their powers to change county aggregates, and to adjust valuations as among various classes of property were not always adequate, and they were too frequently handicapped by the limited appropriations available for the collection of equalization data and the installation of improved methods of equalization. In a few cases, notably Wisconsin, the tax commission built up a remarkable system of sales records which was used for many years as the basis of the state equalization.

A second duty was the assessment of certain classes of corporate property. As the tax commissions were created, the state boards of assessment were dissolved and their function was transferred to the new administrative authority.

The third duty was the supervision of the original assessment as this was being made by the local officials. Central supervision of assessment was the new and significant improvement which was introduced with the tax commissions. Until this development appeared, there had been no oversight and control of the local taxing officials anywhere. It meant an attempt to secure more equitable assessments by supervision while they were being made, rather than by deferred, long-range equalization alone.

While this administrative evolution has been peculiarly bound up with the history of the property tax, it is also true that there has been, especially after the tax commissions had demonstrated their worth, a general tendency toward extending their field of authority over other taxes.

Income and inheritance taxes were locally administered in the beginning, but they have been quite generally transferred to state control. Unfortunately, there is still some tendency to leave various taxes scattered, for administrative purposes, around the state house, instead of concentrating all of them under the logical authority, which is the tax commission.

State tax administration has been slighted in some of the reorganization codes that have been written for state governments, not from deliberate intent, but from reluctance to mar the effects of a neat formal arrangement of departments by recognizing the more important practical elements in the situation. Many of these codes make the tax commission a bureau or division under the state department of finance. This is superficially logical, but it may have bad effects on tax administration. The legislature is too often inclined to treat it as a mere bureau, from the appropriation standpoint, and the local officials are less inclined to respect its authority since it is placed in a subordinate position.

SOME TESTS OF GOOD TAX ADMINISTRATION

It is appropriate to suggest at this point some of the tests by which the quality of the administration of any tax may be judged. This outline must be confined to the tests or requirements involved, and cannot be extended to show how they may be most effectively met. In some cases greater centralization of the administrative process, or more effective central supervision of it, may be required; in other cases, decentralization of the process may be in order.

Three of the four maxims which Adam Smith proposed relate to tax administration. These are expressed in the words *certainty*, *convenience* and *economy*. Broadly understood and applied, they would cover in a general way much of the ground. But a modern summary should be expressed more definitely in the terminology of tax administration. So stated, the essential requirements of good tax administration appear to be these:

Prompt and accurate determination of the assessment. To accomplish this, definite and clear instructions to the assessing official and the taxpayer are essential. The quality of the manual or regulations containing these instructions is usually a good index of the quality of the tax administration in general.

Adequate facilities for prompt, full and final adjustment of complaints. The administrative processes will be unable to dispose of all complaints, for some of them will involve the construction of the tax law and must be dealt with by the courts. A continued, large volume of litigation is always an indication of serious defects, either in the law or in its application by the tax administrator.

It should be noted, also, that the review agencies should be sufficiently

accessible to taxpayers, and the proceedings before them sufficiently informal, to prevent excessive costs of adjusting complaints. A government may save unduly in its provisions for review, at the expense of taxpayers, especially the small taxpayers, who face the dilemma of overlooking the grievance and paying whatever is levied, or of incurring expenses for the appeal that greatly exceed the amount of the tax overcharge.

The preparation of assessment and tax rolls. The nature and purposes of these instruments of tax administration has already been explained. Their use transforms the procedure of assessment, whatever the base, and the levy of the tax, from an informal affair, evidenced often only by casual papers and documents, into a formal, authentic, official determination of the assessment and the tax. In taking money from the taxpayer for public purposes the government should, for its own protection as well as for the protection of the one who pays, establish all of the facts material to this act in official rolls which become the basis for the collector's warrant of collection.

Prompt and certain determination of the tax. The principal hindrance to meeting this test will be in the delay that may arise in determining the assessment. There should be no delay in establishing the amount of the tax liability, however, after the assessment has been settled.

Completeness of collection. The collection process should be arranged with due regard to the maxim of convenience, but the tax administration is defective if it lacks sufficient control over collections to prevent the favoritism, delay and general carelessness that have often characterized this step.

Auditing control over collections. Unless there is a tax roll, the auditing of tax collections is not easy, and the misuse, even the diversion of public funds is possible.

Economy. Smith said that the tax should take as little as possible out of the pockets of the people over and above what it put into the treasury. This is a sound rule for those taxes that are supposed to put something into the treasury. No absolute limits can be set for the expense ratio, but experience indicates that in general it should not exceed 2 or 3 per cent, after the initial expenses of equipment and other costs of setting up the administration have been met. There will be exceptions, for much depends on the number of taxpayers to be dealt with and the amount of tax to be paid by each one.

The economy test would hardly be applicable to taxes of a regulatory nature, since they may cost, in inspection and other ways, far more than the incidental receipts produced. As to these, however, it is hardly possible to apply the ordinary criteria of tax administration, since they are essentially policing rather than revenue activities.

CHAPTER XX

Taxes on Incomes: General Description

THE PAST generation has witnessed rapid extension of the income tax, promoted by a popular belief that it is the one perfect tax. It was used by the federal government during the Civil War but was discontinued after 1872. It has been continuously in force since 1913.¹ It is also found, in some form, in about three-fourths of the states. While income tax laws conform in general to a pattern that has now become fairly definite, they are far from agreement, both as to detail and as to policy. Further, there is no consistency, even in the income tax law of a given jurisdiction. The continual changing and tinkering by legislation, by judicial construction, and by administrative rulings, render futile any effort to present a comprehensive account of the income tax. These changes produce an ever greater complexity, and as the taxpayer's capacity to understand and interpret the law is diminished, his dependence upon commentators, expert accountants, and legal specialists increases. The income tax has enabled this large group to defy that economic principle which holds that a substantial return is justified by substantial risks.²

In the present chapter this method of taxation is described in general terms. Some issues of theory and policy involved in the income tax are discussed in the following chapter.

Persons subject to income tax. The term *person* includes both individuals and corporations. A few states apply the income tax to corporations only, while in a few others individuals only are affected.

A tax on personal incomes should logically apply to the income of estates and trusts, in so far as this income is to be distributed to, or accumulated for the benefit of persons who would be subject to the tax if they were in direct possession of the income. Under these circumstances the return may be made and the tax paid by the person receiving the income, or by the administrator or fiduciary who is in control of the property which provides the income. Naturally, if any part of the net

¹ For a history of the federal income tax, see R. G. and G. C. Blakey, *The Federal Income Tax* (New York, 1940).

² A member of the Ways and Means Committee said of the excess profits tax of 1940:

"The only persons who will make any money under this law will be the tax experts hired by the businessmen to explain it."

income of an estate or trust is distributed in any year, the recipient thereof must report and pay tax on that actually received, while the fiduciary must report and pay the tax on any undistributed net income.

Partnership income is always taxed to the partners. No income tax law recognizes the partnership or the sole proprietorship as business entities analogous to the corporation for tax purposes; nor does any tax law recognize, in the case of partnerships and sole proprietorships, a distinction between income withdrawn for personal use and that retained for addition to surplus and reinvestment in the business. Partners must report and pay the tax on their respective distributive shares of the total partnership income, whether such net income has been distributed in whole or only in part.

Income subject to tax. There are two methods of determining what income shall be subjected to taxation. One is actual receipt, the other is geographic origin. The former rule is the more generally used. The federal government and all of the states except those mentioned below, tax residents on their entire net income from all sources. Minnesota and Wisconsin use the rule of geographic origin, taxing all income found to have its origin within the state, whether received by residents or non-residents, and exempting all income originating outside the state, even if received by residents. Three other states have a limited rule of origin. Mississippi permits a resident who regularly maintains and personally operates a business owned by him and having a physical situs without the state to omit the income therefrom from his gross income. South Carolina permits deduction of income from a business or investment in property in another state, and Oregon allows exclusion of rents and business income from property outside the state.

In all jurisdictions that tax non-residents the tax applies only to the income received from sources within the taxing state, such as compensation for personal services and the income from property or business definitely located within the state. This practice obviously leads to double taxation of certain incomes unless adjustments are made. The simplest and most satisfactory adjustment, if non-residents must be taxed, is exemption on a reciprocal basis.

Determination of taxable income. Modern income tax laws impose the tax on an artificial concept called *net income*. Since there is no absolute economic or legal category that can be identified as net income, no income tax law undertakes to define it, or even to determine it, except in an indirect way. That is, net income is the difference between the sum of certain classes of receipts, called *gross income*, and the sum of certain classes of deductions from that gross income. Both the inclusions in gross income and the deductions therefrom are arbitrarily determined.

Gross income is said to include wages, salaries, commissions and other forms of compensation for personal services, however paid; interest,

rents, dividends, royalties and other forms of income from property and investments, profits; and all other kinds of receipts and income. If the intention is to tax gains from the sale or other disposition of property, the description of profits will be broadened to include such gains, otherwise it will refer simply to the profits on income from business, trades, professions and employment. Certain other kinds of cash receipts will be excluded from gross income, when the purpose of the law is not to tax them. The more important of these are: life insurance proceeds; the value of property acquired by gift, bequest or inheritance; tax-free interest; compensation for accident or illness under insurance or compensation acts; and the rental value of houses occupied by ministers. The list is in part logical, in part sentimental, but it has become an established feature of the income tax formula.

The deductions from gross income in arriving at taxable net income fall into some eight or nine main classes, although there are numerous variations in the different income tax laws. The deductions are:

Ordinary and necessary expenses of operating the trade, business, profession or employment which produces the income. Such expenses would include wages and salaries, cost of materials and supplies, rent of premises occupied but not owned, fuel, and other similar payments incident to the conduct of the business.

Interest on indebtedness. The usual rule is to permit deduction of all interest on debt except that paid on debts incurred to carry an investment the income of which is tax-exempt, such as exempt bonds.

Taxes. There is great diversity of practice in allowing deduction of taxes. All income tax laws permit deduction of property taxes, and none allow deduction of special assessments and other charges purporting to create corresponding value in the property improved. Some states permit deduction of federal income tax, others do not. From the beginning, the federal law has permitted deduction of state taxes on income, but not of its own tax. As the tax rate progression has become steeper, the effect is a drastic increase of tax because the high rates must be applied to that part of the taxpayer's receipts which the government takes as well as to that part which is really available for personal use. A defense of this practice is that by allowing the deduction of federal income tax, the tax rates would need to be much more severe than they are in order to get the revenue. One reply would be that perhaps too much is being taken through this tax.

An anomalous situation often exists with respect to the various excise taxes. These are usually paid to the government by the manufacturer or distributor and shifted to the consumer, who becomes the real tax-bearer, although he is not technically the taxpayer. Whether the consumer is to be allowed deduction of excise taxes depends on the wording of the law imposing these taxes.

Losses. Losses fall into two main sub-classes. One class includes the losses of a sort that could be, but often are not, covered by insurance against fire, theft, marine disaster or other casualty. Such losses, to the extent not covered by insurance, are everywhere deductible with respect to property used in business or held for profit. The other class includes the business or entrepreneurial losses. This class also comprises two divisions—one is the loss arising from the ordinary operation of the business, the other is the loss incurred in the sale or other disposition of capital assets, whether used in the business or held as an investment for profit.

The former is known as a *net loss*, the latter as a *capital loss*. The two tend to overlap, since many business operations, especially of a commercial sort, involve the purchase of goods, wares or merchandise at one price and their sale at another. In a sense, dealers in groceries, real estate or securities are buying and selling capital assets. Their profits or gains are capital gains, and their losses are capital losses. But in all such operations, the goods or other property constituting the dealer's stock in trade will be listed in his books of account. There will be an inventory, and the profits or losses for the year will be shown by the inventory, the purchase and the sales records, after allowing for all other necessary and legitimate deductions.

The distinction between net loss and capital loss may be illustrated as follows, disregarding the many qualifications that actually enter. If a grocer loses money during the year on the sale of groceries, it is a net loss. If he sells his store building at a loss, or sells other property not connected with his regular business at a loss, it is a capital loss. Contrariwise, profits from the sale of groceries are ordinary net profits, and profits from the sale of the store building, or of other property are capital gains. Capital gains are regarded as income, but the manner of their taxation has varied under different laws. Furthermore, the allowance to be made for both capital losses and business net losses has varied, and from 1933 to 1939 the latter were entirely disregarded.

The provisions found in income tax laws for determining losses—and gains—and those specifying the conditions under which, and the degree to which, losses when ascertained may be deducted in computing net income, are usually the most complicated of all to write, to understand or to apply.

Bad debts. The deductibility of a bad debt from gross income may depend on the circumstances under which, and the purposes for which, it was created, and on the policy of the particular law respecting capital losses. All laws permit deduction of a debt incurred in the course of the regular trade or business, if found to be uncollectible and charged off on the taxpayer's books. The federal law permits, in the discretion of the commissioner, deduction of reasonable additions to a reserve for bad debts

Depreciation. This means a deduction for the recovery of wasting assets. For example, a machine wears out in use. An allowance must be made for this wear before it can be said that a profit has been earned from the use of the machine. All income tax laws authorize deduction of reasonable allowance for depreciation. Obviously this involves the exercise of judgment because of the difference of opinion as to how long the equipment will last in use, and discretion is always given the administrative authority to regulate the amount of this deduction. Even so the problem is difficult, for it inevitably involves the determination of the value of capital assets and also a determination of their probable period of usefulness. Provision is also quite generally made for special deductions or reserves against obsolescence, or the premature discard of property before it is worn out, because of improvements.

Depletion. This means the exhaustion of the capital value of a limited resource such as a mine, an oil well, or a tract of timber. Part of the return to the owner in such a case is regarded as a return of capital, part as income. Income tax laws always authorize deduction for depletion, but complicated provisions of law, and still more complicated regulations, have been found necessary to control this group of deductions.

Charitable contributions. The federal law and that of all states except Arkansas, Massachusetts, Minnesota and West Virginia permit deduction of income given to any charitable, educational, religious or other recognized welfare agency. The state laws usually require that the agency be organized and operated within the state. The proportion of net income thus deductible is 15 per cent except in Mississippi and Wisconsin, which allow 10 per cent.

Various unusual or exceptional deductions are found in the different laws. Wagering losses, when mentioned, are allowed only against wagering gains. Massachusetts permits deduction from business income of 5 per cent of the assessed value of property taxed in the state, less any mortgages thereon. The privilege does not apply to shipping. Wisconsin authorizes deduction of expenditures on forest crop lands.

Rate structure. The federal government and all of the states except Massachusetts, Ohio, New Hampshire and Vermont tax personal incomes at graduated rates. Seven western and southern states tax corporation income at graduated rates, although on what theory is not clear. The federal law has used, from the beginning, a normal tax and a surtax. During the period 1916-1934 the former tax was graduated. In the other years it was a single rate. The surtax has always been graduated. The variations in the federal surtax rates may be seen in the comparison of minima and maxima under the various laws given in Table XXXIV.

These changes reflect the varying pressure for revenue. During the first World War the surtax was pushed down to the \$5,000 level while the maximum rate was advanced to 65 per cent. In the 1920's the surtax

minimum was raised again and the maximum rate was reduced to 20 per cent. The fact that this reduced rate applied to all income in excess of \$100,000 was, of course, a definite advantage for the large incomes. During the depression years the surtax minimum was reduced to \$4,000 and the minimum surtax rate was raised above 1 per cent for the first time in the history of the federal income tax. The burden of the surtax rates reached its high point in the act of 1944, with a minimum of 20 per cent on the first dollar of surtax net income, and a maximum rate of 91 per cent on all income in excess of \$200,000. A slight reduction was effected by the act of 1945, both by an adjustment of the rates and by the privilege of deducting an amount equal to 5 per cent of the total tax as computed.

TABLE XXXIV

MINIMUM AND MAXIMUM AMOUNTS AND RATES OF SURTAX IN THE SUCCESSIVE
FEDERAL INCOME TAX ACTS

<i>Act</i>	<i>Minimum Bracket of Net Income Subject to Surtax</i>	<i>Rate on Minimum Surtax Bracket</i>	<i>Surtax Net Income Above Which Maximum Surtax Rate Applied</i>	<i>Maximum Rate of Surtax</i>
1913	\$20,000-50,000	1%	\$ 500,000	6%
1916	20,000-40,000	1	2,000,000	13
1917	6,000-7,500	1	5,000,000	65
1918	5,000-6,000	1	1,000,000	65
1921	6,000-7,500	1	200,000	50
1924	10,000-14,000	1	500,000	40
1926	10,000-14,000	1	100,000	20
1928	10,000-14,000	1	100,000	20
1932	6,000-10,000	1	1,000,000	55
1934	4,000-6,000	4	1,000,000	59
1936	4,000-6,000	4	5,000,000	75
1941	0-2,000	6	5,000,000	77
1942	0-2,000	13	200,000	82
1944	0-2,000	20	200,000	91
1945	0-2,000	17	200,000	88

Personal credits. The allowance of a certain amount of income to the taxpayer, free from tax, is universal. This allowance or credit is taken after the net income has been determined. The amount remaining after the deduction of the personal credits is the taxable income.

Like the rates of surtax, the amount of the personal credit and allowance for dependents has varied with the revenue need. For example, in 1918 married persons were allowed, under the federal law, a credit of \$2,000 and single persons \$1,000. These amounts rose to \$3,500 and \$1,500, respectively, in 1926. They were later reduced in successive revenue acts to \$500 for each person, including the taxpayer and his dependents, in the act of 1945.

The credit for dependents first appeared in the 1916 law. It was \$200

until 1921, when the amount was raised to \$400. In 1941 this figure was reduced to \$350, and raised to \$500 by the act of 1945. This act broadened the definition of dependent to include any person, standing in specified degrees of close relationship to the taxpayer, who received more than half of his or her support during the year from the taxpayer. In earlier laws there had been an age limit of 18 years in determining dependency for income tax purposes.

Earned income. No state law now differentiates between so-called earned and unearned income, although the experiment was tried in North Dakota in 1919. Such a distinction was put into the federal law in 1924, eliminated in 1932, restored in 1934, and eliminated again in 1943. The earlier procedure was to allow a credit of 25 per cent of the tax on earned income. To determine this credit a separate computation of the tax on earned income was necessary. Since this type of income is not clearly identifiable in all cases, notably when the income is a product of personal effort in connection with capital, as in the case of an individual who uses his own capital in a business, arbitrary limits were set to the amount of income which could be regarded as earned for purposes of the tax credit. In 1924 this limit was \$10,000; it was raised to \$20,000 in 1926, and to \$30,000 in 1928. When the credit was restored in 1934, the taxpayer was permitted to deduct 10 per cent of his earned income in arriving at taxable net income for normal tax purposes, subject to the further limitation that the deduction should not exceed 10 per cent of the net income. The upper limit on the amount of income that could be deemed to be earned was \$14,000, giving a maximum credit on this account of \$1,400. Since the normal tax rate was 4 per cent, the maximum tax advantage was \$56.

The assessment of income and the levy of the tax. As explained in Chapter XIX, *assessment* means the determination of the tax base. Under the income tax the tax base is the amount of taxable net income. The technically correct procedure of assessment and levy, in the case of the income tax, would involve the preparation of an assessment roll, in which the amount of each person's taxable income would be set down, and the preparation of an income tax roll, in which the amount of each person's tax would be entered. Except in New Mexico and Wisconsin, no income tax roll is prepared.

The defense for not following this procedure is that the number of returns to be processed in this way is too great. Much delay would be involved if there were to be a final determination of the taxable income and of the amount of tax due thereon in advance of tax payment. In consequence, taxpayers are required to file returns, on which they have determined by their own methods and according to their own interpretation of the law, the amount of taxable income and the amount of tax due thereon. Verification of these returns comes later.

The final review and determination of federal tax have been speeded up by the establishment of field divisions, each of which is a completely organized unit of administration and audit for the examination of accounting and other records of taxpayers for the final determination of income, profits, estate and gift tax liability. The field officers now have authority to close cases by agreement with taxpayers. In 1944, the field officers assessed \$327,592,718 of additional tax by agreement, which was 87.4 per cent of the total additional tax assessed.³

While reliance upon taxpayer declarations is still the typical assessment procedure for the income tax, this method has been modified with respect to the smaller incomes consisting of wage or salary payments, under the Current Tax Payment Act of 1943. Provision is now made for tax withholding by the employer, under a set of tables indicating the amount to be withheld at each pay period, according to the number of dependents claimed. These tables are arranged, also, to take account of deductions equivalent to about 10 per cent of total income. All persons whose income does not exceed \$5,000, and who do not have more than \$100 of income other than wage or salary (such as interest or dividends) are thus enabled to discharge their entire income tax liability through the withholding method.

The tax withholding plan applies to all payments for personal service of a regular or periodic sort, regardless of the size of the income. The tax withholding tables for wage and salary incomes above \$5,000 are designed to provide tax payment at the source of an amount of tax approximately equal to that produced by the normal tax and the first surtax bracket together. Those with incomes above \$5,000, and all who receive more than \$100 of interest, dividends, or income other than salary, must file on or before March 15 a declaration of anticipated income for the year, and pay one-quarter of the estimated total, after taking account of the amount estimated to be withheld. These declarations may be amended at any subsequent quarterly period.

The device of withholding and current tax payment is an excellent improvement over the former method of income declaration and payment of tax on a given year's income in the year following its receipt. It solves a major problem of tax administration in the case of small incomes, which is the difficulty of securing returns and collecting the tax. It would be possible, by appropriate adjustments in the tax withholding tables, to collect even more currently from the larger salary incomes than is now done.⁴

³ *Annual Report of the Commissioner of Internal Revenue*, 1944, p. 21. For a discussion of the organization of federal tax administration, cf. The Committee on Postwar Tax Policy, *A Tax Program for a Solvent America*, Ch. 13.

⁴ The idea of regarding the income tax as a current liability was first proposed by Mr. Hugh J. Reber, of New York City, in an unpublished memorandum. The first publication of the idea, with due credit to Mr. Reber, was the present writer's paper,

Information returns. All income tax laws provide for information returns, which are used to verify the taxpayer's declaration of certain types of income received. Employers send to the administrative authority lists of employees receiving wages, salaries or other compensation for services above a certain minimum. Ownership certificates are required for bond interest coupons. Lists of stockholders with the amount of dividends received by each during the year provide a check on this form of income. There remains a considerable volume of income such as the profits of individual entrepreneurs and the personal earnings of the professional group, which can be ascertained only from the statements and business records of these taxpayers.

Secrecy of returns. The federal government and all of the states except Wisconsin provide for secrecy of the information contained in income tax returns. Access to these returns is permitted for any necessary judicial or other official inquiry, and, on a reciprocal basis, when requested by the income tax authorities of other jurisdictions. Efforts have been made to change the federal practice, and on two occasions these were successful. The act of 1924 required the commissioner to prepare and make public lists containing the name of each person making a return, with his address and the amount of tax paid. In 1926 only the address was to be given, and the provision was eliminated entirely in the act of 1928.

The publicity requirement was restored in the act of 1934, in broader form than before. The taxpayer was to set out, on a separate statement, his gross income, total deductions, net income, credits for purposes of the normal tax, and tax payable. A pink slip was supplied with the returns for 1935 for this purpose. Fortunately, this provision was repealed before any publicity was given to the details supplied by taxpayers in the notorious pink slips of 1935. The lists containing this information would have been a happy hunting ground for the blackmailer, the kidnapper, the confidence man and the unscrupulous competitor, but they would have served no useful public purpose.⁵

In connection with the returns for 1936, the bureau required each

"A Current Basis for Income Tax Payment," in *The Watch Dog*, Vol. 7, No. 10, December, 1941, published by The National Economy League, New York.

⁵ The secrecy provision was repealed in Wisconsin in 1923, and in 1930 the tax commission stated that there had been no instances in which public inspection had brought forth unreported income, while it had inclined taxpayers to consolidate and condense their reports in order to make them as unintelligible as possible to the public, thus increasing the difficulty of official audit and examination. Some further statements were the following. "A survey shows that public examination is almost wholly without any public motive or significance, but that advantage is taken of it to serve purely private and personal interests. . . . Many examinations are made out of curiosity, and at times for the sole purpose of annoying and harassing a reporting taxpayer." Credit men, security salesmen, advertising agencies, and business competitors were also mentioned as making extensive use of these records. Cf. *Report of the Wisconsin Tax Commission*, 1930, pp. 193, 194.

taxpayer to file a duplicate return, the announced purpose of which was to provide a set that could be examined by state tax officials without interruption of the regular audit of the originals. Whether the public advantage of this requirement will be sufficient to compensate for the added irritation produced by it, is at least questionable, for there are still more than twenty states in which no personal income tax exists and from which, therefore, few if any inquiries would come for information regarding income tax returns. This requirement was suspended in 1938.

Time of payment. The practices of the states vary as to the time of payment. South Carolina, Utah, Virginia and West Virginia require payment in full with the return. California, Louisiana and Georgia allow payment to be made in three installments. The remaining states are about equally divided, one group following the federal policy of quarterly payments and the other group permitting two installments. North Carolina authorizes two installments only if the tax exceeds \$100. Whenever installments are accepted, the first must be tendered with the return as it is filed.

Tax offsets. The tax offset must be distinguished from the deduction of taxes from gross income. When an offset is permitted, it means that some other tax, such as the property tax, may be used to diminish the amount of tax to be paid under the income tax. A person who had paid property taxes during the year, might present these tax receipts in settlement of his income tax, for which purpose they would be received as the equivalent of cash up to such amount as he was permitted to offset.

Wisconsin inaugurated the tax offset in 1911, by permitting the deduction of personal property taxes from the income tax. The original purpose was to safeguard the revenues during the experimental period of income taxation, but the privilege was tenaciously held and did not disappear from the law until 1927. A few other states have permitted an offset, but New Mexico is the only state now using it. All taxpayers may offset one-fifth of their property taxes paid in the state on property the income of which is taxed. Resident individuals may, in addition, offset the property taxes paid on a residence owned and occupied, to an amount not exceeding \$250.⁶ No tax offsets have ever been permitted under the federal law.

Penalties. There is usually an attempt to adjust the penalties for income tax violation according to the gravity of the offense. Under this type of law the various offenses range from omission or misstatement due to absentmindedness to deliberate intent to evade. Mere omission of an item of income through inadvertence or lapse of memory, but without intent to evade, is usually penalized by a moderate addition to the tax, with interest on the unpaid amount. When there is evidence of fraud-

⁶ For vigorous and convincing criticism of the offset policy under the income tax, cf. H. D. Simpson, "The Effect of a Property Tax Off-Set under an Income Tax," *Proceedings of the National Tax Association*, 1930, pp. 220-228; *ibid.*, 1931, pp. 126-134.

ulent intent, expressed through failure to submit a return, or by filing a false return, the penalty may be both fine and imprisonment. Under the federal law it may be ten years in prison plus a fine of \$10,000. A prevalent maximum among the states is one year in prison and \$1,000 fine. Massachusetts denies to persons convicted of income tax violation the right to hold office in the state for five years, in addition to possible fine and imprisonment. In a few states the prison sentence is omitted, the penalty for fraud being a severe increase of the tax levy on the income found to be omitted. All of the states impose additional penalty tax for some offenses, notably the failure to make a return of income.

The weak point in the enforcement provisions of income tax laws is the obligation to prove fraud or fraudulent intent, since the distinction between fraud and inadvertence is hidden in the mind of the taxpayer. High tax rates provide added incentive to evade, in this as in other tax laws. The great majority of those whose incomes are so large as to subject them to high rates must, for personal and business reasons, keep fairly accurate records of income and outgo, and these can, of course, be examined in auditing the returns. More difficulty has been encountered in dealing with individuals whose incomes are derived from shady or illegal enterprises, and in dealing with the cases arising under ambiguous provisions of law, or under vacillating construction of the law by the bureau.

CHAPTER XXI

The Income Tax: Principles and Policies

THE SIXTEENTH AMENDMENT to the federal constitution, relating to income taxation, was written to surmount a specific barrier, namely, the direct tax clause. That clause requires any direct federal tax to be apportioned among the states according to population. A tax on land had been consistently declared by the Supreme Court to be a direct tax. In the income tax cases of 1894 the court held that a tax on the income from land was as much a direct tax as if it were a tax on the land itself.¹ Since a tax on the income from land could not well be apportioned among the states according to population and since this form of income could not well be omitted from a general income tax, this ruling compelled the abandonment of federal income taxation until the constitutional obstacle could be removed.

This was done in the Sixteenth Amendment, which became effective as of March 1, 1913. It is as follows: ²

Congress shall have power to tax income from whatever source derived, *without apportionment among the several states and without regard to any census or enumeration.* (Italics supplied.)

There is no definition of income in this language. The absence of any explanatory or limiting clause indicative of what the word *income* means implies that Congress is free to make its own definition. This it has done, subject to certain guidance and direction from the Supreme Court. While the court has final authority to say what income is, and Congress is bound to keep within the limits of the definition, there is no reason why it may not apply the tax to a more restricted income base than the court has laid out. Thus, stock dividends have been held not to be income and the tax law must recognize this rule. On the other hand, realized capital gains

¹ *Pollock vs. Farmers Loan and Trust Co.*, 157 U. S. 429.

² The income tax cases of 1894 involved a second issue which was not dealt with at all by the Sixteenth Amendment. This was the tax on municipal bond interest, which the court said was equivalent to taxation of the bonds, and therefore equivalent to taxation of the instrumentalities of a state government. Since such taxation involved interference with the powers and freedom of action of the state, it would be repugnant to the concept of dual sovereignty, and would undermine the foundations of the federal system established by the constitution.

have been held to be income, but this has not prevented the application of special methods of tax treatment to this class of income.

In the absence of a clear constitutional definition of income, the tax could be based upon gross income as well as upon net income. The latter concept has been selected, but it is not always expressible in positive and absolute terms in particular situations. Much of the difficulty of administration and litigation has arisen out of the problems involved in income determination.

INCOME DETERMINATION IN GENERAL

It is commonly believed that income is something which is so clear and definite as to present little difficulty of definition or determination. The learned justices of the Supreme Court have frequently referred to the ordinary person's view as to what income is, and they have often professed to interpret statutory terms in accord with these everyday concepts.³

The ordinary person's conception of income is usually derived from his experience with wage or salary payments, which are the simplest and least complicated of income forms. Yet the curbstone understanding of income, even in these simple forms, does not extend even to such a matter as the difference between gross and net wage or salary income.

In the case of other forms of income, particularly that derived from business operations or transactions, the determination of income is a complicated matter, although it is often assumed otherwise by the uninitiated. The reason for the complexity is that business enterprise is a continuing process which does not provide neatly packaged results for a given period such as a fiscal year or a tax year. In any twelve-month period, some operations which were begun in an earlier period will be finished, others will be started but not concluded, while still others will be opened and closed. The accountant's reckoning of the outcome of all these processes in their various stages of accomplishment is cast up at regular annual intervals for the guidance of management, the information of the owners, and the reports to various governmental agencies including the treasury. The annual statements are cross-sections of the business stream. The statement of profit or loss is at best only a reasonably close approximation, not an absolute finding of fact. Some of the items involved in determining the income are definite. Examples are the amounts paid for labor service, for materials and supplies, and the amounts of cash received for the sale of product. Other items involve the exercise of judgment. Among such items are the proper allowance for the depreciation or obsolescence of tools and other wasting assets, and the fair market value to be assigned to an asset in an exchange or transfer which may

³ Roswell Magill, *Taxable Income* (1945), pp. 19 ff.

involve gain or loss. Much of the controversy between taxpayers and income tax officials arises in the large area in which judgment, estimate, and opinion are involved in the determination of income.

In order to compute a tax for the year, however, it is necessary to set down certain figures in the tax return. In view of the possibilities of error of judgment, it is clear that taxable income cannot always be determined with final and complete accuracy, even with the best of intentions on both sides. Because of the approximative character of the income statement, a policy of moderation in the tax rates imposed and in the administration of the law seems obviously indicated.

It would also appear desirable that the judgments of management with respect to those matters which do involve estimate and opinion should, in general, be accepted rather than the judgments or opinions of the income tax examiners. The Committee on Postwar Tax Policy recommended that this be done, on the ground that the objective of business accounting is to arrive at as nearly correct an approximation of the results of each business unit as possible. As long as standard accounting practices are uniformly observed, it was proposed by this group that the results should be recognized and accepted as leading to a reasonable income result for tax purposes.⁴

Although this is a somewhat technical subject, it may be worth while to summarize here the general principles of depreciation accounting as set forth by the authority just cited:⁵

1. Taxpayers should be permitted to amortize the full investment in all assets subject to wear and wastage in use, or to loss of utilization value through obsolescence.

The economic basis of this principle is clear. If a person has invested x dollars in a machine to produce certain goods, it is certain that the machine will wear out in a given period of years. Unless he is permitted to include in his costs a charge representing the depreciation of the machine, he will presently find himself with a worn-out machine and with no provision for the replacement thereof. This means that he has been selling the product of the machine at less than its actual cost.

2. No taxpayer should be allowed to write off more than the full value of a depreciable asset, or be required to terminate the charge-off short of such full amortization.

Again, the economic significance is clear. The taxpayer is entitled to recover the full amount expended for the machine, but not more than that amount. If the machine cost \$10,000, and is expected to be useful over a ten-year period, the normal charge against receipts would be

⁴ *A Tax Program for a Solvent America*, pp. 90, 91.

⁵ *Ibid.*, pp. 92, 93.

\$1,000 a year for the ten-year period. The principle stated above says that the deductions should not total more than \$10,000, but that they should equal this amount, unless the machine is sold at the end of eight years. In that event the adjustment of depreciation should take into account the scrap value realized. If this should be, say, \$1,000, then only \$1,000 of additional depreciation should be allowed.

3. While good business policy demands that the amortization of a particular asset be complete by the time this asset is ready for the scrap heap or other disposal, there is no reason for requiring that the depreciation rate be adjusted to some predetermined period of maximum useful life.

This refers to a policy of the Treasury whereby the depreciation allowance was to be spread out over such period of useful life as may have been determined by it. In the example just mentioned, if the Treasury determined that the maximum useful life of the machine were twenty years, then the annual deduction for its depreciation would be \$500 a year. The result would be that the owner would show \$500 more each year in taxable income than if he were to deduct \$1,000 a year.

The flaw in the Treasury logic is clear enough. If the taxpayer is permitted to deduct \$1,000 a year for the first ten years of the life of the machine, he can deduct nothing thereafter, and if he does keep it in use for twenty years, his taxable income is the greater by \$1,000 a year for the remainder of the twenty-year period. If there be no change in tax rates, there is neither gain nor loss for the Treasury or the taxpayer, so far as the revenue is concerned.

The principal advantage from speedier depreciation is that the taxpayer is better in position to scrap the old machine and introduce an improved model, if such be available, if he has already depreciated the old model. This may be illustrated as follows: if the taxpayer must observe the strict Treasury rule, he will deduct only \$500 a year for the depreciation of his machine. At the end of ten years his undepreciated value is still \$5,000, whereas if he had been permitted to follow his own inclination, the machine would have been fully depreciated in that time. Suppose that within the first ten years a new and better machine appears. If the old machine has been fully depreciated, or nearly so, there is no barrier to the introduction of the new machine. If the producer must still reckon with half of his investment in the old machine, he is likely to retain it until the recovery of its cost has been more nearly completed before he scraps it for the new machine. At any rate, an improvement which would be profitable to introduce if the existing equipment were fairly well depreciated, may not be profitable if the loss on existing equipment must be added to the cost of new equipment.

4. Tax administrators are entitled to make sure that taxpayers do not accumulate depreciation reserves in excess of the cost or other basis of de-

preciable assets. The rate and the manner of accrual, within the reasonable limits of generally accepted accounting principles, should be left to management.

The purpose of this recommendation is self-evident. The taxpayer should not be permitted to deduct depreciation for a machine that is already fully depreciated. On the other hand, the manner and rate of deducting for such costs, within the limits of some generally accepted method, should be left to management rather than to the Treasury.

Net losses. It is important, also, to recognize that the accounting results shown for any given income year are not necessarily conclusive that a taxable income has been earned. There may have been a net loss in a prior year. When a business firm does experience a net loss it means that more has been paid out, or incurred as costs in some form, than has been realized in receipts. The net loss involves payments out of capital in order to balance the difference between receipts and expenses. In order that the capital shall be conserved, the first charge against profits, when earned, is the replacement of the lost capital. Only after this has been done can it be said that net income has been earned. For example, if a business loses \$50,000 in one year and earns \$50,000 in the next year, the net income for the two years is zero. If the tax were to be imposed on the profits when reported, without regard to the adjustment for losses, it would cut heavily into the ability of the business to maintain its capital, and hence its ability to earn income in future. It would be, in effect, a tax on capital rather than on income.

The proper policy here would be to permit a balancing of the losses against the profits. This may be done either by a carry-back of the losses against the profits of earlier years, or by a carry-forward of the loss against subsequent profits. The former would involve a refund of the tax already paid on the earlier profits; the latter would mean that no tax liability would exist until the loss had been covered by the later profits.

In ordinary times, the net loss carry-forward is generally regarded as the better solution. The principal advantage of the loss carry-forward is that it avoids the need for Treasury refunds after the money has been collected and spent. Notwithstanding their economic soundness, such payments, especially in large amounts, expose both the Treasury and business to demagogic attack. They may, also, be difficult to finance if there should be a close balance between revenues and expenditures in the years when the refunds must be made. Moreover, the carry-forward accords better with the spirit of enterprise, which always looks to the future rather than to the past. The privilege of bringing losses forward for adjustment against profits when earned is likely to be more of a stimulus than the recovery of tax against past income. The knowledge that taxes will not be levied against future profits until losses have been absorbed, will be a spur to enterprise.

There is general agreement that the carry-forward period for losses should be liberal. In theory, it should be indefinite, in that there should be complete freedom to apply losses against future gains until the losses have been fully covered. The administrative difficulties involved in keeping tax returns open until all of these adjustments have been made are such as to indicate some definite period, such as six or seven years, rather than an uncertain future period. Both management and the Treasury would find advantage from the termination of the adjustment after some liberal number of years.

Capital gains and losses.⁶ The subject of capital gains is one of the most controversial in the whole field of income taxation. A capital gain is the amount of increase in the value of a capital asset over its cost or other basis of valuation in the hands of the seller. There must be a realization of the gain through sale or conversion before the question of tax liability will be raised. Corresponding to the capital gain is the capital loss, which is realized when the asset is sold or exchanged at a figure below its cost.

Two major issues of theory and policy may be identified. The first and more important one is whether or not a capital gain is income. The second acquires significance only if it be determined that capital gains are income. In that event, the question arises as to how this form of income should be taxed. The alternatives are (1) to employ some sort of differential tax such as has been applied by the federal law since 1921; or (2) to require the inclusion of net capital gains, that is the gains minus the losses, with other income for taxation at ordinary income tax rates.

The first point to be noted is that the term *capital asset* has been given a limited scope by the tax law. A capital asset is not just any asset which may be set up in the balance sheet as a part of the capital. The tax law excludes from the category of capital assets two major groups of assets. One group consists of the property which is accounted for by inventory methods, such as stock in trade, raw materials, goods in process, and finished products awaiting shipment. The other group includes those forms of property subject to depreciation, such as machinery, buildings, and other wasting assets, the cost of which is recoverable under depreciation accounting.

These rules narrow the field of the so-called capital assets. They remove a large part of the assets of the ordinary business concern from the area of controversy. The gains and losses incurred in buying and selling the capital goods in the excluded categories are considered to be ordinary business gains or losses. As such, the losses are offset in full against the gains and only the net gains are carried into income. Moreover, the market transactions in which inventories are involved are ordinarily short-term operations that go on continuously and that do not give rise

⁶ This discussion of capital gains first appeared in *The Tax Review*, May, 1946.

to serious questions regarding an accretion of value over a considerable period. With respect to the depreciable assets, the result of depreciation accounting is provision for the recovery of a substantial part, if not the whole, of the investment in the asset during its useful life.

This leaves us involved, so far as concerns the legal concept of capital assets and the gains or losses to be realized therefrom, chiefly with those investments which are indicative of the ownership of some sort of right or title to earnings and equities, as against the operating property that is used in the production of goods and the earning of income. While corporations own such investments and are subject to an accounting for capital gain or loss through sale, exchange or other disposition of them, the bulk of the investments which are classified as capital assets is owned by individuals. It would be an over-simplification to say that the principal issue in the definition and treatment of capital gains and losses arises from the ownership of securities by individuals. Nevertheless, this aspect of the problem overshadows all others.

The first question that must be dealt with is whether or not the gain realized from a sale or conversion of a capital asset is income. The enumeration of the forms of income in all of the income tax acts since 1913 has contained the words—"gains or profits from sales or dealings in property." Because of this language in the law, the Supreme Court formulated the following definition of income in *Eisner v. Macomber*:⁷

Income may be defined as a gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through sale or conversion of capital assets.

This definition of income does not constitute proof, based upon careful economic analysis, that a capital gain is income. The proviso was thrown in because it was in the law. Had the law lacked all reference to gains from sales or dealings in property, it is reasonable to assume that the court's definition might have lacked the proviso. In contrast with the above definition of income is the following, written by an English judge in construing the English income tax which emphasizes, for tax purposes, a concept of income quite different from that found in the federal law.⁸

...an accretion to capital does not become income merely because the original capital was invested in the hope and expectation that it would rise in value; if it does so rise, its realization does not make it income.

In an economic sense, there is no difference between income in England and income in the United States. Geography does not alter funda-

⁷ 252 U. S. 189.

⁸ Lord Buckmaster, in *Jones v. Leeming*, quoted by Magill, *Taxable Income*, 1945, pp. 86, 87.

mental economic facts. Local conditions may, and often do lead to quite different legislative policies based on the same facts. The differences between the statutory determination of what shall be included in taxable income in the two countries indicate the effects of the local ideas, institutional factors, and national purposes. In neither case can it be said that there has been a serious effort to decide what income is, and what is the proper relation between income and capital value.

This relation is one of cause and effect. Income is the cause and capital value is the effect or result. For example, a corporation owns and uses plant, machinery, and materials in its appropriate producing operations, but this equipment is excluded, for the most part, from the category of capital assets by definition. The corporation's securities are capital assets in the hands of the owners thereof. If the business operations of the corporation result in a profit, the securities have a value. If there is no present or future prospect of earnings, the securities are worthless except for such salvage value as may be realized from disposition of the physical equipment. Normally, a business corporation is expected to produce earnings more or less regularly in future. A share of its stock has value because it represents an equitable interest in these earnings, whether they are distributed as dividends or are retained as surplus. Technically, the amount of value which the share of stock has is the present worth of the expected series of future income installments that the holder may receive, or that may be accumulated for his beneficial interest as surplus. Put in another way, the capital value of the share of stock is the capitalized value of its proportionate part of the company's income. This is the only way by which so intangible a thing as a share of stock can acquire value.

Various influences may operate to change the value of a capital asset. Among the more important of these influences are the following: (1) a change in the absolute amount of production, such as the creation and sale of more units of product with corresponding increase of earnings per share; (2) a change in the price level, which causes differences in the dollar amounts received from the sale of the products; (3) a change in the rate used in capitalizing the income installments.

It follows, therefore, that the value of the capital asset may change because of variations in earning prospects; or it may change because of price variations, even though there be no difference in physical output of goods and services; or it may change, regardless of any of the above variations, because of fluctuations in interest rates. In short, the capital value, or the value of the capital asset, is no more than a reflection of the true income. This capital value is the image in the mirror. It may be magnified by price increases or by a decline in the capitalization rate; or it may be reduced to less than life-size by changes of prices or the interest rate in the respective contrary directions. It is mistaking the image for the reality to regard the changes that occur in the reflected and

derived value of the capital asset as being, in any sense, income. There should be no confusion as to the difference between income and capital value. The latter is never income. Its changes merely reflect, they do not produce or create, changes in income. In *Eisner v. Macomber*, it was said.⁹

...mere enrichment through increase in value of capital investment is not income in any proper meaning of the term.

This is clearly the case. It bears out what has been developed above with respect to the nature of, and the relation between, true income and its capitalized value. On the basis of the logic set out here, which indicates that an increase of capital value resulting from one or more of the influences that may be operative as income is capitalized, is not income, the question arises as to why the net amount of this rise should be regarded as income when the holder of the capital asset sells or converts it into some other form.

The Supreme Court has replied as follows: ¹⁰

In determining the definition of the word "income" thus arrived at, this court has consistently refused to enter into the refinements of lexicographers or economists and has approved, in the definitions quoted, what it believed to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the Constitution.

This sounds like the acceptance of hearsay evidence, for there was no documented recording of what was in the minds of the people when the income tax amendment was ratified.¹¹ Since the ratification was by state legislatures, the popular mind was probably a total blank on this subject. We do know from the records that in New York there was concern over the dangers of runaway progressive taxation and that the word went out to the members to vote for the amendment only upon assurance from Washington that such could never happen. The Supreme Court has never explored this topic, although it was perhaps more prominent in such popular thinking about the income tax as occurred around 1913 than the meaning of income.

The above explanation means that the court has sought to define income as the man in the street would define it. In the popular thinking conditioned by the fact that from early colonial times the people have been extraordinarily speculation-conscious, the sale of a capital asset for more than was paid for it results in income. That which is sold in the case of a corporation stock, for example, is the capitalized value, or the present

⁹ 252 U. S., 189, at 214, 215.

¹⁰ *Merchants Loan and Trust Co. v. Smietanka*, 255 U. S. 509, at 519.

¹¹ There is something about the court's language quoted above that brings to mind the one thing that Mr. Dooley was sure about in his famous discussion of a Supreme Court decision. It was that no matter whether the constitution follows the flag or not, the Supreme Court follows the election returns.

worth, of the claim or right to certain future installments of income. If the stock has risen in value during the period of ownership, the rise has merely registered the improvement in the prospects of receiving income in the future.

The owner is no richer after the sale than before. His wealth exists in a different form. Both the Supreme Court and the man in the street believe that the act of converting his wealth into another form has, in some mysterious way, caused income to appear out of the void, so to speak, since there is no contention that the income existed prior to the sale.

The recognition of a realized capital gain as income implies that the gain is in some way severable, that it can be diverted to consumption or in payment of tax, without impairing the wealth of the owner. The man in the street would certainly consider that such a gain is severable and spendable without adverse effects. This belief underlies the conception that a capital gain is income. It is, however, without foundation.

A simple illustration may make the point clearer. Suppose that back in the 1920's an investor bought enough shares of stock to secure an annual dividend of \$1,000. The long-term interest rate then was around 4 per cent, and if the annual dividend had been capitalized at this rate, an investment of \$25,000 would have been involved. Suppose further, that the corporation grew and prospered and that in due course the share of the corporate income distributions to which this investor would be entitled by reason of his stock holding rose to \$5,000 a year. Assuming no change in the capitalization rate, his stock would then be valued at \$125,000 provided there were good prospects of continuing to receive income at the rate of \$5,000 annually. However, if it be assumed that the capitalization rate had declined along with the drop of long-term interest rates to, say, 2 per cent, then his stock would be valued at something like \$250,000. In the event of a sale, his capital gain in one case would be \$100,000, and in the other it would be \$225,000. The Supreme Court, the Treasury, and the man in the street would be in agreement that income had been realized through sale of the stock.

But what, exactly, did the investor sell and what did he gain thereby? Actually he sold his stock certificates, but essentially, he sold his rights to an annual income of \$5,000 from the corporation, together with his right to vote in stockholder meetings and to participate in net asset realization upon liquidation. Since prosperous corporations do not ordinarily contemplate early liquidation, the value of the liquidating right would be negligible. The important fact is that our investor has parted with his rights to a certain income. He has received in exchange the present worth of the series of future income installments, to which he, as a shareholder, would have been entitled had he retained ownership of the stock.

There is one way of looking at the transaction which could lead to

the conclusion that the proceeds of the sale constituted income. This view stems from the fact that the sale value of the stock represented the present worth of the expected future income. Instead of holding and receiving the income throughout an indefinite future, he has bundled up the future income installments into a lump sum, i.e., the amount received for the shares. He therefore has in hand the actuarial equivalent of the future income as a result of the sale. This idea is much too esoteric, however, to be the basis of curbstone thinking about the nature of income.

On this basis, the entire proceeds of the sale would be income, for the amount realized was the capitalized value of the current and prospective dividend of \$5,000, and not the value of the present dividend less the \$1,000 which he received in the early days of his investment. Also, since the transaction is a present summation of future expected income payments, the proper method of taxing such income would be to require the inclusion of a portion of it in each subsequent year's tax return until the whole had been reported. At a capitalization rate of 4 per cent, this period would be 25 years, and at a rate of 2 per cent, the period would be fifty years. To include the total realized for taxation at progressive rates in the year of realization would be a gross discrimination against this method of gaining income.

The present method of taxing long-term capital gains represents a rule of thumb compromise with the proper procedure (assuming that the capital gain is income), although it is justified on the ground of a gradual growth of the capital value in the past rather than on the ground that this value is a summary in anticipation of expected future income payments. To avoid the numerous complications involved in spreading the total over a period, whether into the past or into the future, a certain percentage of the total gain is taken in lieu of more precise adjustments.

But there is also a way of looking at the transaction which leads to the conclusion that the gain, as such, is not income. We start, as before, with the fact that the capital value is the reflection of the succession of future income payments to be expected. These payments have attained the level of \$5,000 a year, at which they are presumed to continue. At a capitalization rate of 4 per cent the mirror of capital value reflects a value image of the magnitude of \$125,000. The solid reality is the annual income return of \$5,000. So far as investment principles are concerned, the \$125,000 as a capital sum is significant only in that it represents access to and command over an annual income of \$5,000. If we assume that the investor's primary desire and purpose is to assure for himself a continuance of such an income, then it follows that he must safeguard and reinvest the entire proceeds realized from the sale of his stock. To spend any part thereof, or to pay out any part of it as a tax, would impair his capacity to obtain an income equal to that which he received before the sale. In other words, the proceeds of the sale is his capital fund which

is applied, through reinvestment, to obtain income. The appreciation of his capital from \$25,000 to \$125,000 was not income, nor did it produce or create income in the process of growth. It was the result of the growth of the true income which was the annual payment made to him by the corporation.

Instead of reinvesting, our investor could decide to hold his \$125,000 in cash and spend any or all of it for consumption purposes during the remainder of his expected life. In such a case he would be treating it as income, and we would have no option but to agree with him. A moral from this is that the intention of the investor who possesses a capital fund is important in determining how it shall be regarded. This would be true whether the fund had been accumulated from past earnings, or had been a gift or bequest, or had grown through an advance of market prices. Dr. Roy Blough has recently commented on capital gains in words which suggest that the intention of the recipient may be significant as to their classification as accretions to capital or income. He said, in part: ¹²

There are so many different ways of looking at them (i.e., capital gains) which affect the attitudes toward their taxation. Thus, one person watching the rise and fall of security values may conclude that capital gains are not income at all but accretions to capital and that as such they should not be taxed. Another person, observing the fur coats, jewelry, entertainment, trips to Florida, and other expenditures being financed from capital gains will be convinced that capital gains are certainly income, at least in the minds of the people who receive them.

The owner's intention is not, however, a wholly feasible basis for administering a tax. The practical question then arises—is it better policy to assume that all who realize capital gains intend to regard the proceeds as capital, or to assume that all intend to regard the proceeds as available, in part or in whole, as spendable income. There should be no tax under the first assumption, and there should be one under the second.

In this writer's opinion the first assumption is more realistic, and hence more advantageous as a long-run policy. It is true that the casual or occasional trader is likely to regard a profit on a lucky deal in the market as a clear gain which can be spent for any consumption purpose without impairing his economic position. This group is of small importance and its gains and losses could well be ignored, even under present law, so far as the revenue is concerned. By and large casual trading operations are disregarded in England. It is extremely doubtful, however, if any of those whose holdings run to substantial amounts are so frivolous as to be indifferent to the investment implications of their possessions. They would ordinarily plan to offset every sale fairly promptly by an investment elsewhere. Their objective is the maintenance of their income flow,

¹² An address before the Eastern Spring Conference of the Comptroller's Institute of America, New York, April 15, 1946.

the true economic income, and they would look upon their capital funds as the means of acquiring and maintaining command over true income.

If this assumption as to the prevalent attitude of investors toward their funds be correct, it follows that they do not look upon an appreciation of capital as income. In shaping policy it would be appropriate to take into account the views of those who, out of their own experience, are expert in such matters rather than the views of those who have no such experience, like the man in the street. Legal recognition of the fact that investors generally do not regard capital appreciation as income would remove a serious restriction from the capital markets, and thereby contribute greatly, both to the investment flow and to the most competent direction and use of the capital funds. Even the tax revenue would not suffer in the long run, for the removal of the barrier now imposed by the taxation of capital gains as income would very likely lead to a greater annual flow of true income.

Stock dividends. A stock dividend is a distribution to shareholders in corporation stock rather than in cash. Ordinarily the dividend consists of the corporation's own stock which is issued on a pro rata basis to the holders who are entitled thereto, but it may consist of the stocks of a subsidiary company owned by the payor company. The courts have held that a stock dividend is not income, on the ground that its issuance made no change in the relation of the several shareholders to the corporation. Each has more shares, but the same proportion of the new total. In other words, there has been no realization of income. The original judicial viewpoint has been modified to the extent of holding that when the stock issued as a dividend gives the stockholders rights or privileges which they did not enjoy before, the dividend is taxable as income. Examples would be the issue of stock in another company, the issue of preferred stock to common stock holders, or vice versa.¹³

INDIVIDUAL INCOME TAXATION

All income that is produced by the economic system eventually is received by individuals and all taxes, however levied, are ultimately borne by individuals. From these premises it has been argued, by some, that the simplest and best tax system would be one which concentrated the bulk of the tax load upon individual incomes, as such.

It is doubtful if such a tax system would really be the best that could be devised. There are no generally acceptable principles for the distribution of such a tax among individuals. The popular slogan, "ability to pay" throws no light on the problem, for it is still an open question whether ability taxation is best attained by a proportional tax rate, or by a moderate progression, or by a steep progression. Moreover, if the income tax

¹³ Cf. the discussion and cases cited in Magill, *op. cit.*, Ch. II.

to be used were to be patterned upon those now extant, millions of persons would pay no tax at all, and billions of dollars of income would be untouched.

Extreme concentration of the tax upon incomes would be less acceptable to the citizens than a diversity of taxes. Psychological as well as economic factors are involved. The payment of excise taxes in small amounts as purchases of taxable commodities are made is no doubt more satisfactory to the user of these articles than would be the addition of an equivalent tax to be deducted or paid from his income at the end of the year.

Individual net income. While the tax law has developed a statutory definition of net income for the taxation of individual income, this concept is not accurate because of the existence of various costs of gaining income which are not recognized by the law. Net income is primarily a business concept. In the business realm it means the product or income that can be withdrawn from the business unit without impairing its capacity to produce more income. If the withdrawal should exceed true income, it would mean dipping into capital. The importance of allowing adjustment for all business losses before arriving at net income has already been emphasized. As applied to business, the distinction between what it is proper to withdraw and what must be conserved is clear.

In a free society the individual exists and operates in a dual capacity. He is both a producer of income and a consumer. While a reasonably close approximation could be made of the costs which he incurs as a producer in gaining income, the result in many cases would be that little or no true net income remained in the business accounting sense. And yet, the costs which he must meet, for food, clothing, health, shelter, recreation, and all of the things which serve to maintain his health, strength, and morale as a worker who produces income also provide his satisfactions as a consumer. The income tax dilemma is that while all of these costs should be allowable from the standpoint of determining individual net income, yet their allowance would seriously undermine the base of the individual income tax.¹⁴

The dilemma has been resolved, in practice, by permitting the individual to make certain deductions from his income, while denying other items which are as truly costs as those that are allowed. The deductions are patterned after the provisions applicable to business firms. They include such expenses as interest, taxes other than those on income, bad debts, losses not compensated for by insurance, and payments of rent, wages, etc., directly connected with the individual's professional or business operations which produce the income.

Two other deductions should be allowed. One is medical expense, for

¹⁴ Cf. H. Lutz, "Some Errors and Fallacies of Taxation as Exemplified by the Federal Income Tax," *Proceedings of the National Tax Association*, 1941, pp. 355-380.

the receipt of earned income is interrupted by illness or injury. The law now permits deduction of medical expense to the extent that the amount exceeds 5 per cent of net income but this takes care of only the final portion of an exceptional bill. The restriction should be removed. Another deduction which should be permitted is for premiums on life insurance. It is particularly incongruous to enforce payment of a tax for old age and survivors' benefits and at the same time to deny a deduction for tax purposes for the payments which are voluntarily made to make provision for old age or for the care of dependents. It is equally odious to consider plans for compulsory health insurance while giving no recognition to the costs which self-supporting individuals must meet in order to earn income. It is as if the state had greater interest in the development of a compulsory system of health and old age assistance, under government control, than it had in the voluntary action of individuals whereby the need for public action along these lines might be lessened.

Imputed income. At an early date in the history of the income tax the Supreme Court held that realization was an important test of the receipt of income. This means that various kinds of beneficial advantages which can be classed as part of real income, but which are not actually realized in money, are not to be regarded as income for tax purposes. Examples are the rental value of owner-occupied residences, the garden produce consumed by the gardener or the farm family, the income value of automobiles, radios, etc. From time to time proposals are made to require a valuation of such income for tax purposes. The administrative problem would be enormous, both for the Treasury and for the individuals who would be obliged to maintain records for the purpose of accounting for deductible costs of production, depreciation, maintenance expenditures and the like. The revenue that might be realized would hardly offset the practical difficulties involved.

Earned income. Individuals may acquire a right to income in two principal ways. One is by giving personal service of some sort, the other is by being possessed of titles to property, or to equitable interests in property. The return to personal effort may consist of wages, salary, commissions, or the returns from managing an enterprise. Property incomes may consist of rent, royalty, interest, dividends, or gains from dealings in property. When the distinction is observed in tax laws, the returns to personal effort are designated as *earned income*. By implication, property incomes would be regarded as *unearned*, although this term is never used in tax laws.

The contrast and the connotation are alike unfortunate. Another set of terms more to be preferred is *funded* income, used to designate income from property, and *unfunded* income, which means income from personal effort of any sort. The essential question is whether the source of income warrants differential tax treatment.

Two lines of argument have been set up to support some sort of tax differential in favor of earned incomes. One may be described as economic, the other as political. The economic argument proceeds from the relation between reward and effort. Individuals will make greater effort to gain income through physical or mental labors when they are allowed to keep relatively more of what they earn. Therefore, some kind of tax advantage is said to be warranted in the case of incomes which depend directly upon the effort expended in gaining them. The political argument recognizes that a reduction of the tax rates on large incomes, both funded and unfunded, cannot be secured without a compensating advantage to wage and salary incomes, the bulk of which falls in the lower income brackets. This advantage has been given by various devices for allowing a tax reduction on earned incomes. The first earned income credit in the federal law was introduced in 1924, in connection with a further downward revision of surtax rates from the high levels attained during the first World War. The credit was liberalized in 1926 and 1928 as additional surtax reductions were made. The credit was disallowed in 1932 and 1933. Its purely political character is evidenced by the fact that when it was restored, in 1934, the maximum tax relief available to any taxpayer was \$56. The economic advantage of a credit of such an amount must be completely discounted. The earned income credit, even on this limited scale, was eliminated by the revenue act of 1942.

Putting aside the aspect of relative economic desert, a connotation which almost inevitably enters as the terms *earned* and *unearned* are used, the important question is the effect of the tax burden on the functioning of the whole economy. Stated in terms of the earned income credit the issue is: Are labor and other personal services of every sort so much more important to the attainment of production, jobs, and income than the services of saving, investment, and risk assumption whereby capital is provided, as to warrant a substantial differentiation in the tax burden to be imposed on labor and capital incomes, respectively?

Sober economic judgment compels a negative answer. The Committee on Postwar Tax Policy arrived at the conclusion that the most vigorous functioning of the whole economy would be realized when there were uniformity of the initial rates of tax applicable to incomes of every sort. This group also emphasized that all taxation is burdensome and that it operates, in all its forms, as a brake or deterrent upon the motives and incentives of individuals. Taxation can never be a direct incentive to economic effort. By lessening the burden through expenditure control and by equalizing it at least to the extent of removing favors and penalties through a uniform initial tax rate on all forms of income, the maximum results are likely to be achieved toward promoting the vigor of enterprise.¹⁵

¹⁵ *A Tax Program for a Solvent America*, p. 135.

The averaging of income. The hardship involved in making an annual tax return and computing tax on the income received in each year is especially marked in the case of variable incomes. Thus, two persons might receive the same total amount in a five-year period, but because one income was the same from year to year while the other was much higher in some years than others, the second would pay more tax on total income than the first. This results from the severe progression of the tax rates. It has been suggested that permission be given, in such cases, to average the income over a period and pay tax for each year on the average as if it were the total annual income. The law now permits this, over a three-year period, under certain limited conditions.

The fact that such a suggestion could be made, or requires to be made, is an indictment of a severe tax rate schedule. The relief would be more effective under certain rather limited conditions. The idea is that all taxpayers be permitted to do this without the narrow restrictions of the present law. If it were given through moderation of the tax rates, furthermore, the administrative difficulties would be serious, and they would expand progressively with the extent of the averaging period. Despite the appeal that such a proposal makes, avoidance of extreme tax rates would be far simpler.

Joint returns. The Committee on Postwar Tax Policy made the following recommendation on this subject: ¹⁶

Married persons should continue to have the right of making a joint return but there should be no compulsion upon them to do so. Marriage should not involve the loss of tax rights that existed before.

This is a sound position. From time to time the Treasury has advocated a compulsory joint return, the only purpose of which would be to force the combined income of husband and wife into higher tax brackets and thus to increase the total tax to be paid. The result would be, also, a determination of the tax on one person's income by reference to the income of another. Thus, a woman who had been receiving an income of \$5,000 before marriage, on which a certain amount of tax was payable, would find that the tax on that amount of income would be materially increased by the fact that it had to be combined after marriage with her husband's income of \$20,000. The revenue to be gained by this kind of arbitrary treatment would not be sufficient to counterbalance the taxpayer resentment that would be engendered. If each person has an obligation to pay income tax, he should also have the right to pay tax upon his own income only.¹⁷

Community property returns. Under the laws of eight states property acquired and income received during marriage is recognized as commu-

¹⁶ *Ibid.*, p. 108.

¹⁷ Cf. H. L. Lutz, "The Right to Pay Income Tax," *Bulletin of the National Tax Association*, Vol. XXI, p. 111.

nity property and income, respectively, which means that each spouse has a vested interest in one-half thereof, whether or not earned by himself or herself. The Supreme Court upheld this principle in 1930.¹⁸ In most of these states the principle is derived from the old Spanish law and became established there while the areas now comprised in these states were under Spanish jurisdiction. Its ancient lineage indicates that community property is not a diabolic invention introduced to defeat the purposes of the federal income tax, although some of the attacks upon the principle imply that such is the case. It is true that the equal division of income in the tax returns of husband and wife result in a lower tax than would be paid if all income were to be reported in one return. But according to the legal logic, half of the income belongs to each, and each is therefore fully entitled to make the return and pay the tax on his half. There is in this no discrimination against taxpayers in other states which could not be overcome by the introduction of the community property principle. If husbands elsewhere are not willing to enter into such an arrangement, the inference is that they have reasons sufficiently urgent to make the heavier taxes the lesser evil. It is foolish, therefore, to waste sympathy on them, as it would be highly inequitable to deny to the citizens of the community property states a privilege which their own laws confer. Any other state would need to enact a thoroughly complete and straightforward community property law, however, or it would suffer the fate of the Oklahoma law, which provided merely an option to spouses who elected to accept its provisions.¹⁹

Dividends. The payment of income tax by both corporations and individuals raises the issue of double taxation, in that the shareholders are taxed on the income which they receive as dividends which, as corporate income, has already been taxed. The subject has various aspects, some of which are controversial. For example, it is often asserted, especially by business men, that the corporation income tax is shifted to consumers in higher prices. If this be true, or to the extent that it is true, no double tax is involved when the dividends are taxed to the persons who receive them. While such shifting may and probably does occur, its extent is limited, according to the evidence and the reasoning to which the present writer has had access.²⁰ The point has also been made that, regardless of the double taxation that may be involved, the entire structure of stock market prices has become adjusted to the situation through the capitalization of dividend income after taxes. That is, investors buy and sell stocks on the basis of the actual dividends to be received. Assuming that the prices established are such that the dividend payments actually made

¹⁸ *Poe v. Sanborn*, 282 U. S. 101.

¹⁹ Rejected by the Supreme Court, so far as a division of income for federal tax purposes is concerned, in *Commissioner v. Harmon*, 323 U. S. 44.

²⁰ *Supra*, Chapter XVIII. Also, H. L. Lutz, *Guideposts to a Free Economy*, Ch. IV.

represent a reasonable, or at least an acceptable return, on the investment, then the stockholder experiences no burden on account of the taxes paid by the corporation. It would certainly appear more realistic to assume that stock prices are related to and influenced by the actual dividends rather than the earnings per share before allowing for the corporation tax. Only if a reduction of the rate of corporation tax were in prospect would there be an advantage in pricing stocks with reference to the per share earnings.

Moreover, it would be true that the sudden introduction of a substantial credit to stockholders on account of the double tax would create a "windfall" appreciation of stock prices. Thus it would be difficult to avoid a serious dislocation of the stock market price structure. Taking all factors into account, some have been disposed to make no change on the ground that it would be jumping from the frying pan into the fire.

The difficulties which are envisioned, and others which may be conjured up, would eventually be surmounted. The important problem is whether there would be a sufficient long-range advantage from some sort of adjustment to warrant undertaking it. On this point there appears to be fairly general agreement in the affirmative, although there have been various proposals for accomplishing the desired result. Some would exempt corporations from the income tax, and make up the loss of revenue from higher individual income taxes. For political reasons it would probably not be possible to do this, even if it were desirable on economic grounds. Such a course would be a serious discrimination against unincorporated business, the net income of which is taxable in full to the individual owners. Moreover, there would remain the problem of undistributed corporate income which would not be taxed at all unless some sort of undistributed profits tax were imposed. But such a tax would be particularly severe upon new and growing companies which needed to retain a substantial part, or even all, of their earnings for expansion purposes.

Since it is likely, in any case, that corporations will continue to be taxed, any one of various methods might be employed to correct the double tax situation.²¹ The one which has been most generally considered is a tax credit of some amount to the stockholder. This has found favor notwithstanding its potentially serious effects upon stock prices. Historically, the credit was provided by exempting dividend income from the normal tax. This privilege was withdrawn in 1935. Prior to the tax rate increases brought about by the financial burdens of the second World War, this concession represented a much larger proportion of the total tax burden on dividend income than would now be the case. The Committee on Postwar Tax Policy proposed that the credit be calculated at

²¹ Cf. the discussion of these methods in *A Tax Program for a Solvent America*, pp. 123 ff.

the tax rate applicable to the first bracket of taxable income, after determining the total tax by including dividends with other income. To avoid refunds, the credit should not exceed the total tax due.²²

THE PLACE OF THE INDIVIDUAL INCOME TAX IN THE FEDERAL REVENUE SYSTEM

Taxes on individual incomes will always occupy a prominent place in the federal revenue system. While this statement is indisputable, it affords no clue to the kind of individual income tax that the federal government will use, or should use. Some tax planners have proposed that this tax should be virtually the only one of importance in the federal tax repertoire.²³ Naturally, the rates would need to be heavy and the progression steep. Others have recognized that the individual income tax will be important, but have counseled that a fairly broad revenue base should be maintained because of the known instability of the income tax under variable economic conditions.²⁴ In this writer's opinion, no adequate case has ever been made for the federal taxation of so-called net incomes of individuals at progressive rates as against the method of income taxation employed under the social security legislation. The essential difference is fairly well understood, but some of the details are worth restating.

The method of income taxation that has been employed since 1913 involves a tax on an artificial definition of net taxable income which has already been described. The outstanding characteristic of this system is that the taxable income will always be only a minor part of the total of national income payments. It follows from this fact that the tax rates must always be substantial, even heavy, if an adequate revenue is to be obtained. The following data indicate the extent of the gap between income payments and taxable income at different levels of national income:

TABLE XXXV
ESTIMATED NATIONAL INCOME AND TOTAL TAXABLE INCOME *
(BILLIONS OF DOLLARS)

Item	Income		
National income	\$115.0	\$125.0	\$140.0
Undistributed corporate profits, etc.†	4.0	5.3	7.0
Income payments to individuals	111.0	119.7	133.0
Income not subject to tax	71.0	75.0	81.0
Total taxable income	39.9	44.7	52.0

* Source The Committee on Postwar Tax Policy, *A Tax Program for a Solvent America*, p. 263.

† Undistributed corporate profits plus the excess of social security contributions over transfer payments.

²² *Ibid.*, pp. 124, 125.

²³ E.g., B. Ruml and H. C. Sonne, *Fiscal and Monetary Policy* (1944).

²⁴ The Committee on Postwar Tax Policy, *A Tax Program for a Solvent America*.

The personal exemptions and dependency credits used in the above calculations were those allowed under the law in force for 1946, namely, \$500 per person. It will be noted that even at a national income of \$140 billion, the total taxable income is only about three-eighths of the total of income payments. It is necessary to recognize that some forms of income payment included in the national income estimates are not required by the tax law to be reported. Consequently a more accurate notion of the gap between taxable income and the income which might have been subject to income tax is afforded by another calculation presented in the report of the Committee on Postwar Tax Policy. This comprises a reconciliation of income payments in 1942 with the income reported in tax returns.²⁵ In 1942 income payments were estimated at \$117.3 billion. Income reported in tax returns for 1942 amounted to \$87.7 billion, of which the taxable income was \$38.5 billion. However, the income that would have been reportable under the tax law was \$108.5 billion, hence taxable income was 35.5 per cent of reportable income.

The restriction of taxable net income to little more than one-third of total income payments, a ratio which seems more or less definitely established under the \$500 per person exemption regardless of the income level, means that only a minority of the citizens will pay income tax. This situation is less serious if other federal taxes are used than it would be if the income tax were to be relied upon for a large proportion of the total revenue. In view of the fact that federal policies are national policies, that the decisions on these policies reach into and affect every section of the country, and that all of the people should join in passing judgment upon, and in supporting the cost of the federal actions, it follows logically that federal taxation should reach into every section and every economic level. A tax based on net income after deductions and personal exemptions is incapable of meeting such a requirement. By itself, and without broad supplementation of other taxes, the net income tax is not an ideal fiscal instrument for democratic finance.

The method of taxation employed for old age and survivors' benefits is a proportional tax rate upon the first \$3,000 of compensation paid to a worker by an employer in the course of a year. Under this tax there are no deductions, no personal exemptions, no credits for dependents. It is a tax on gross income. Despite this characteristic, numerous proposals have been made to amend the social security law by increasing the rate and the maximum amount of wage income subject to the tax. The social security tax paid by employees is thus directly opposed, in principle and practice, to the net income tax. It has encountered no serious antagonism from those subject to it or from the theorists. While it is ostensibly a payment for benefits to be received, the collections thus far have greatly exceeded the benefit payments made, which means that this tax has been

²⁵ *Ibid.*, Appendix to Ch. 7.

used, in considerable degree, to cover governmental costs which would otherwise have been met by other taxes or by additional public loans. An extension of the method to all incomes would have the merit of bringing all citizens and virtually all income payments into the fold as supporters of the federal services.

Personal exemptions. Assuming that no change is to be made in the type of federal income tax, it becomes necessary to consider the level of personal exemptions and dependency credits to be allowed. The data given in Table XXXVI indicate that these allowances must be kept at or near their present levels in order to preserve even as much of a taxable income base as is now provided. It was noted in the preceding chapter that the amount of these exemptions is always determined by fiscal expediency. Reference to the allowance as an offset for a subsistence minimum is a sentimental subterfuge. By established custom taxpayers have acquired a vested interest in some sort of allowance, and it is therefore continued, notwithstanding that it diminishes taxable income by almost one half.

The tax rates on individual income. The logical and necessary outcome of the small taxable income base which is established under the present type of net income tax is that the tax rates must be relatively high in order to obtain the necessary revenue. This is true, at any rate, of the tax to be imposed on the first bracket of taxable income. The reason is that the bulk of such income will always be found in the first bracket. This may be illustrated by data published by The Committee on Postwar Tax Policy:

TABLE XXXVI

ESTIMATED DISTRIBUTION OF TAXABLE INCOME BY NET INCOME CLASSES AND BY TAXABLE INCOME BRACKETS, AT A NATIONAL INCOME OF \$125 BILLION *
(TAXABLE INCOME IN BILLIONS)

<i>Net Income Classes</i>	<i>Taxable Income</i>	<i>Taxable Income Brackets</i>	<i>Taxable Income</i>
\$ 0- \$ 2,000	\$ 8.51	\$ 0- \$ 2,000	\$30.55
2,000- 5,000	21.28	2,000- 5,000	5.80
5,000- 10,000	5.06	5,000- 10,000	2.85
10,000- 25,000	4.59	10,000- 25,000	2.74
25,000- 100,000	3.74	25,000- 100,000	2.00
100,000- 500,000	1.20	100,000- 500,000	.61
Over 500,000	.33	Over 500,000	.17
Total taxable income	\$44.71		\$44.71

* Source: The Committee on Postwar Tax Policy, *A Tax Program for a Solvent America*, pp 265-267

The term *net income classes* means the income size class or group in which each individual's taxable income falls. Thus, a large number of persons will have a net income, which is gross income less allowable

deductions, between \$0 and \$2,000. The total taxable income which all such persons are estimated to have, under the conditions assumed in the above table, is \$8.51 billion. Another group would have net incomes between \$2,000 and \$5,000. The total taxable income of this group would be \$21.28 billion. A very few persons would have net incomes above \$500,000. The total taxable income for this small group would be \$330 million.

The term *taxable income bracket* means the portion of each income which falls within the indicated brackets. Thus, a person having a taxable income of \$10,000 would have the first \$2,000 of it in the \$0-2,000 income bracket, the next \$3,000 in the \$2,000-5,000 bracket, and the remainder in the \$5,000-10,000 bracket. Since the first \$2,000 of each person's income is in the lowest bracket, the total taxable income in that bracket naturally bulks large. Hence it becomes apparent that the first bracket tax rate must be fairly high if a substantial revenue is to be provided. For example, an initial tax rate of 20 per cent, applied to the taxable income in the first taxable income bracket in the above table, would produce \$6.11 billion, and an initial tax rate of 10 per cent would produce only half as much, or \$3.055 billion. If the initial rate were 10 per cent rather than 20 per cent, the revenue loss arising from this difference in the initial rates would not be made up if there were to be complete confiscation of that portion of every one's income above \$25,000, for the total of such income portions or slices would be only \$2.78 billion. A high initial rate can be secured either by setting the first rate of a single surtax scale at a fairly high figure, or by applying, as the British law does, a fairly high rate of normal tax. The important point is that the revenue loss resulting from too great leniency in the initial rate can be made up only by great severity in the subsequent graduation of the rate scale.

There is some question of the advantage to be had from retaining the historic distinction between normal tax and surtax. Under the act of 1945 the same exemptions and dependency credits are allowed for the normal tax as for the surtax. This, in effect, makes the 3 per cent normal tax an addition of three percentage points to the surtax scale. By combining the two, the single graduated scale under the 1945 law would begin at 20 per cent and rise to 91 per cent. The principal reason, legally, for retaining the distinction is that the interest on certain issues of federal bonds is exempt from normal tax but not from surtax. The amount of these bonds outstanding is diminishing, and all will be retired or refunded within a decade. The Committee on Postwar Tax Policy proposed a single tax rate scale, with a provision for regarding the first 3 percentage points of each bracket as the normal tax, for all purposes of the Internal Revenue Code.²⁶ A single rate scale makes for simplicity of tax computation by eliminating the separate normal tax calculation. On the other

²⁶ *Ibid.*, pp. 113-116.

hand, some experts believe that the British pattern, which includes a substantial rate of normal, or standard tax, as it is called in England, affords greater flexibility. It is true that the English standard rate has been changed much more frequently than the surtax scale. There would no doubt be some gain here from settling upon a surtax scale that would be sufficiently acceptable to acquire reasonable stability. Variations in the tax yield would then be sought by merely changing the rate of normal tax. Such a procedure would alter the amount of tax to be paid by every one. For example, suppose that agreement could be reached upon a simple series of surtax rates, applicable to fairly wide brackets, such as the following:

<i>Assumed Taxable Income Brackets</i>	<i>Assumed Normal Tax Rate</i>	<i>Assumed Surtax Rates</i>	<i>Total Tax Rate</i>
\$ 0-\$ 5,000	15	5 per cent	20
5,000- 10,000	15	10 " "	25
10,000- 20,000	15	15 " "	30
20,000- 50,000	15	20 " "	35
Over \$50,000	15	25 " "	40

To ascertain the total tax rate applicable to each income bracket it would be necessary to add the normal tax. If this rate were 15 per cent, it would be equivalent to a total tax rate of 20 per cent on the income in the first bracket, and of 40 per cent on all income in the top bracket.

An arrangement such as the above would make the following points perfectly clear. First, that every one having taxable income would pay a flat rate of some amount upon the entire income. This is the normal tax plus the first bracket surtax. Second, that there would be some, but not too much differentiation of the additional tax to be imposed upon incomes because of size. This is the surtax. It was emphasized in an earlier chapter that there is no scientific basis for a progressive tax scale. Therefore, in devising such a scale, the primary concern should be to avoid the repressive effects upon the economic incentives which are produced by undue severity. The point was made by a group of post-war tax planners that there is a level well below complete confiscation at which the tax rates in the upper brackets operate just as surely to eliminate further progress as though the rates were made 100 per cent.²⁷ The long-run gain to all who have low incomes will be greater if the deadening effects of extreme tax rates are avoided than if a temporary advantage to the revenue be sought through excesses which defeat their own purpose.

The revenue to be obtained through the individual income tax will depend upon all of the factors that have just been mentioned—rates, exemptions, volume of national income payments, and so on. It is charac-

²⁷ *The Twin Cities Plan, Postwar Taxes*, 1945, p. 17.

teristic of this tax that the yield varies with the degree of prosperity experienced. An expansion of total national income means that individual incomes are larger. More persons have income, and more income is found in the higher tax brackets. Loss deductions from income are relatively less. The reverse conditions develop as total national income declines. In consequence, the net income tax can be relied upon to produce abundantly in prosperous years, but not in depression years. An illustration of this expansibility is provided by the collections since 1940. In that year the individual income tax produced \$982 million, or 17.2 per cent of total federal revenue. In 1945 it produced \$19,034 million, or 40 per cent of total revenue. There were changes of rates and exemptions over the period, but an even more important factor was the rise of total income payments.

An important problem of future fiscal policy is whether to maintain tax rates high enough and exemptions low enough to raise the proportionate contribution to federal revenues from this source to as much as two-thirds or more of the total, or to devise a tax system sufficiently diversified to hold this proportion at more moderate levels. As budget requirements decline, the former objective would be attained by holding the line on income tax while eliminating excises and other taxes. Such a system would operate reasonably well in the good years. It would be likely to involve budgetary difficulties in adverse years. A diversified revenue system, in which the individual income tax would be an important unit though by no means the main stay, would have the merit of assuring greater stability to the federal revenues under all sorts of business and economic conditions.²⁸

A new income tax year. The income tax law has always permitted any person, firm, or corporation to report income and pay tax on the basis of his or its fiscal year, which may be selected according to personal preference or business requirements. For good reason, permission will always be given to change this fiscal period. All income taxpayers who do not elect to report on a fiscal year basis are required to do so on the basis of the calendar year. This is true of the great bulk of individuals who receive wages, salaries, interest, dividends, and other incomes not directly derived from a business pursuit.

In the interest of more direct relationship between the budget and the tax burden, it is suggested that the income year and tax year be changed to coincide with the federal budget year, which opens on July 1. The transition would involve one additional report to close out the income received and tax liability for the six months between January 1 and June 30. Thereafter all who now use the calendar year, and who would not elect to continue using it, would report and pay tax for a year beginning July 1 and ending the next June 30.

²⁸ This was the recommendation of The Committee on Postwar Tax Policy, *op. cit.*, Ch. II.

The great advantage from this arrangement would be that all tax rate changes would then become integrated with the budget which made the reductions possible or the increases necessary. The great body of income taxpayers would become more overtly aware of the connection between the spending and the taxing. In time they could even develop a more acute sense of balancing the benefits against the burdens. In any event, the essential facts of benefit and burden would be placed before them in one package, namely, the overall budget of expenditures and revenue requirements which is now provided for under the newly established legislative budget.

A tax on spendings. The case for basing the individual income tax on the amount spent for consumable goods and services rather than on the net income received has been vigorously argued.²⁹ The basic idea is that savings from current income should not be taxed. All spendings—defined as any use of income other than savings—would be taxable at progressive rates. An exemption of moderate amount to each taxpayer should provide freedom from the tax of the amounts spent on necessities.

The plan was advocated during the second World War as a device for siphoning off some part of the surplus purchasing power which could not be spent currently because of rationing and other restrictions. It has not been considered seriously as a peace-time tax measure. Its emphasis upon the advantage of saving is meritorious, but the proposal to promote and reward saving through a tax exemption is open to serious criticism. It would lead to large accumulations of funds with no regard for the need of them. The proper inducement to saving is the interest rate in a free capital market. If the economic system requires and can absorb more capital funds, an advance of the interest rate will elicit the necessary saving and investment. On the other hand, a decline of that rate would indicate less need and it should lead to diminished saving for the time being. It is quite as important to maintain consumption as it is to maintain investment. A tax exemption for saving would promote indiscriminate saving at the expense of consumption. Its adoption would be unwise.

It may be noted that a sales tax is a tax based upon or related to spendings, but at a proportional rate rather than a progressive rate. The arguments against a spendings tax are not valid against a sales tax. The latter, being always a proportional tax, imposes no such penalty upon consumption as would be imposed by a progressive rate. Moreover, the sales tax is not pointed at the artificial stimulation of saving without regard to the need and the return to be realized. One can avoid the sales tax by not spending, but his inducement to save rather than spend is always moderate. He is never offered an excessive premium for saving.

²⁹ Cf. Irving Fisher and Herbert W. Fisher, *Constructive Income Taxation*, 1942. Also, Randolph Paul, and others, in *Proceedings of the National Tax Association*, 1942, pp. 249 ff.

CHAPTER XXII

Poll Taxes

THE POLL TAX, also known as a head tax or capitation tax, is a levy at a fixed amount per person, that is, per head. This tax has had a long, and on the whole, unenviable history. It was used by the ancients, often for the purpose of emphasizing inferiority of status in the body politic. It was used by the colonies, and in Virginia the inequalities of this tax as between large and small planters was one cause of Bacon's Rebellion in 1676. Almost a century later, however, the poll tax was still by far the most productive of the Virginia taxes.¹ Resentment against it is expressed in the Maryland constitutional declaration of rights in the following words: "That the levying of taxes by the poll is grievous and oppressive and ought to be prohibited."

Since the colonial period the poll tax has stagnated, and some writers have been disposed to agree with Plehn's characterization of it as "a decaying monument, set up in the past; and like the gravestones in old cemeteries, these remaining poll taxes are moss-grown and leaning, passing memorials to dead democratic institutions of the past."²

It should be a cause for lamenting rather than rejoicing when any democratic institution dies. The poll tax is a passing memorial to the dead and gone concept that all citizens should share, in some degree, the cost of government.

Scope and characteristics of the poll tax. The poll tax is forbidden by the constitutions of four states—Maryland, Ohio, Oregon, and Utah. It is levied directly by the constitution, or is required by constitutional provision to be levied, in twelve states,³ and it is permissive in all except four other states. New York and Wisconsin are alone in having no legislation on the subject. Elsewhere, the legal provisions may impose the tax for state use, or for local use, or for both. The receipts are usually devoted to schools, or to roads and streets. In Connecticut the revenue is used for old age assistance. Vermont applies a portion of the yield to this purpose, and in North Carolina a part is used for support of the poor.

¹ D. R. Dewey, *Financial History of the United States* (1920), p. 12.

² C. C. Plehn, *Introduction to Public Finance* (1926), p. 222.

³ Alabama, Arkansas, California, Delaware, Mississippi, Nevada, North Carolina, Rhode Island, South Carolina, Virginia, West Virginia and Wyoming. Cf. *Tax Systems of the World*, 9th ed., pp. 305-310.

The rates imposed vary, but are moderate in all cases, ranging from one to five dollars except in Louisiana, where it may be as much as \$12.00 in parishes, with the privilege of commuting the tax by performing labor on the roads. In sixteen other states this alternative of paying cash or of working on the roads a specified number of days is found. Under modern highway conditions such labor would be relatively useless, but nearly all of the states that retain the labor commutation provision still have large mileages of unimproved roads.

Two generalizations can be made with respect to the persons subject to the tax. It is not levied upon persons under twenty-one years of age, nor upon paupers or various defectives, such as the blind, the insane and the feeble-minded. Veterans are commonly exempted and other selected groups, such as teachers, firemen, and ministers, may be exempted. In twenty-eight states all persons except those exempted, being between the ages of twenty-one and fifty, or in some states sixty years, are liable. In some states males only are liable for such tax as may be imposed for certain purposes, such as work on roads and streets. Payment of the tax is a suffrage prerequisite in eight states.

From the administrative standpoint, the poll tax runs itself in large measure. Assessment and collection are local responsibilities, and centralized supervision of local taxation, where it exists, has not as yet been concerned with this tax. Except when the individual has some strong reason for payment, such as the desire to vote, it remains largely a voluntary matter. The expense of strict enforcement of the tax has been an important factor in its neglect, even in those states where no serious opposition is expressed on ideological grounds. An indirect approach to a poll tax has been tried in a few states by means of a universal requirement to submit an income return and pay a nominal filing fee, even if no income tax be due on the return. The cost of securing such returns absorbed so large a part of the yield of the filing fees as to warrant abandonment of the policy.

It should be said, however, that the difficulty of collection has not always prevented the imposition of a tax. An example was the \$5.00 federal use tax on motor vehicles. It was necessary to rely heavily upon the coöperation of local police and motor vehicle inspectors to enforce this tax, and this response was not at all uniform. Incidentally, the motor vehicle use tax has some similarity to a poll tax levied on car owners only. That is, it was levied at the fixed rate of \$5.00 per vehicle, regardless of its age or value, or of the mileage to be driven during the year. The tax was the same, also, regardless of the owner's income, or the number of his dependents.

Loud complaint has been raised over the practice of some states in making payment of poll tax a prerequisite to voting. Eventually a Supreme Court may be assembled which will construe the constitutional

provisions which authorize the several states to be the arbiter of their voting requirements in a way that will compel abandonment of the poll tax as a prerequisite to voting in federal elections. The outcry over this matter is disingenuous. There was no such demonstration against the proposition that a motor vehicle owner was committing an unlawful act by driving his car on the highways without the stamp indicating payment of the federal use tax.

But, after all, where is the difference? There are many people, unfortunately all too many, to whom the privilege of driving a car is more important than the privilege of voting. Some never vote, others never bother to register. The absence of a poll tax requirement does not assure a high registration or a high percentage of votes to registered voters in the non-poll tax states.

The critic of the poll tax would no doubt say that the deprivation of the use of a car, through non-payment of the use tax, is a purely private decision which any one is free to make, whereas the deprivation of the franchise through non-payment of poll tax, is an invasion of a constitutional right. The fact is, of course, that there is no deprivation in either case. While the use tax was in effect, the car with a tax stamp on it could be lawfully driven as much as the gasoline ration would permit. The person who has paid his poll tax is legally eligible to vote. It would be as sensible to say that the use tax deprives the car owner of the use of his car as to say that the poll tax deprives any one of the privilege of voting.

Growing out of the difficulty of collection is the fact that there is no practicable penalty for non-payment except in the states which relate it to the voting privilege. Such a penalty, if it may be so called, would not strike the average person as being serious, and in view of the indifference with which others regard the vote, it would be no penalty at all for them. Compare this situation with the penalties provided for non-payment of other taxes. Failure to pay federal income tax when due results in interest at the rate of 6 per cent per annum from the due date to the date of payment. Wilful failure or neglect to file a return may result in the addition of as much as 25 per cent of the tax as a penalty.

Even more drastic penalties are found in some of the states where the poll tax is not tolerated. In both Massachusetts and New Jersey, the law provides, in the case of non-payment of personal property tax, that the sheriff "shall seize the body of the delinquent and hold it in safe and secure custody," or in plain layman's language, put him in jail. The saving element in these dread provisions is that they are ordinarily ignored in practice, although there have been some instances in Massachusetts in which the delinquents were escorted as far as the jail door, an excellent position from which to weigh the pros and cons of tax payment.

If denial of the voting privilege be regarded as the penalty for non-payment of the poll tax, how mild it is, after all, as a penalty by contrast

with jail sentences, or a 25 per cent mark-up of the tax, or even 6 per cent interest on the unpaid amount! Mississippi says to the citizen, white or colored, "You must pay poll tax in order to vote." Massachusetts and New Jersey say to their respective citizens, "You go to jail if you fail to pay the tax levied on your personal property." The federal government goes still farther, with jail sentences up to ten years for the more extreme violations of the income tax law. Those who are in jail on election day for tax delinquency are effectively disfranchised.

This matter of alleged disfranchisement is what causes self-righteous blood pressure to mount among the citizens of those states which provide severe, even grotesque, penalties for non-payment of other taxes. In view of the general attitude of the citizens toward the franchise it is impossible to know how they would react, individually, toward a poll tax prerequisite, except by deduction. The deductive evidence suggests that a great outcry would arise, inspired less by the keen desire to vote than by the unwillingness to pay the tax.

After all, a tax of \$2.00, or even of \$5.00, would not be likely to deter those from voting who really feel that sense of civic responsibility which it is assumed, though without foundation, that all citizens do feel. Voting is the process by which those who vote participate in the selection of public officers and in the popular determination of public policy. It sounds progressive and liberal and big-hearted to say that every adult citizen shall have the right to vote without let or hindrance, without regard to race, color, or creed. But is it really so terrible to ask that the person who is to have a part in the determination of public policy shall have, say, at least a \$2.00 stake in that policy as he expresses his wish at the polls? An important aspect of public policy is always the spending and taxing program of government. Those who oppose any and every sort of qualification for voters except the attainment of a certain age (and the age limit is being reduced in some states), are proposing to entrust the determination of such important matters as public spending and taxing to a group which can, in the nature of things, contribute little or nothing to the taxes and which, at the same time, is certain to be among the principal beneficiaries of the spending.

It may be a debatable question whether a general poll tax requisite for voting would improve the quality of elections. At any rate, it could hardly depress it below the present level, one at which the buffoon and the demagogue often have a better chance than the serious, thoughtful, able candidate. A century or so ago the slogan of universal suffrage was very appealing and it proved effective in removing the property qualifications on the franchise that were then common. In those days neither the scope of government functions nor the burden of government costs was a matter of such importance as to involve the jeopardy of the republic by this broadening of the suffrage.

Fiscal results of the poll tax. The most important aspect of the poll tax is not, however, its use as a selectivity device in connection with elections. Any state, north or south, that wishes to hitch it up with the franchise should be perfectly free to do so. If a poll tax were to be collected regularly from the adult members of the population it would acquire, in some sections, a relatively important revenue significance. This would be more apparent in normal times than it would be during the current inflation. State income taxes, for example, are now providing abnormal returns because of an inflated income base. Under other conditions the income tax is an unreliable revenue producer. The Census Bureau has discontinued, since 1942, separate tabulation of the poll tax collections for state use, and the latest data relative to both state and local collections relate to the year 1932. In that year total reported collections by all grades of government were \$18,458,000. Even for that time this was only a small part of total state and local tax collections. A better idea of the relative revenue importance of the poll tax may be had from a comparison of its yield with the inheritance tax, which is a method of taxation that has widespread sanction and approval. This comparison is made in Table XXXVII.

TABLE XXXVII
YIELD OF POLL TAX AND INHERITANCE TAX in CERTAIN STATES, 1942 *
(THOUSANDS OF DOLLARS)

<i>State</i>	<i>Poll Tax</i>	<i>Inheritance Tax</i>
Alabama	\$ 245	\$ 125
Georgia	300	543
Indiana	881	1,350
Iowa	252	1,491
Nebraska	823	28
Texas	1,312	1,049
Vermont	399	226
Virginia	834	575
West Virginia	680	516
<i>Totals</i>	<u>\$5,726</u>	<u>\$5,903</u>

* Source. United States Census Bureau, *Financial Statistics of States*, 1942

It would be easy to dismiss such a comparison as is made in Table XXXVII by emphasizing the relatively backward economic situation of some of the states listed therein. The point is, rather, that in the states or sections which have only moderate accumulations of wealth, the taxes on the transfer of this wealth at death can never be expected to produce much revenue. Taxes on the living are far more productive.

There is no design here of making a case for the poll tax as the only, or even as the principal, method of taxing living persons. There is a place for it in any community that wants to use it and that is willing to make

reasonably diligent effort both at collecting it and at educating the people to pay it. The Maryland constitution declares that a poll tax is grievous and oppressive. It is no more so than a payroll tax for social security, or than an income tax which involves exposure of all details of one's business, and even of one's private and personal affairs, to a complete stranger.

CHAPTER XXIII

Property Taxation: Characteristics

THE PRESENT chapter will deal with some of the characteristics of the development and present status of property taxation in the United States, and the one following will deal with some of the problems that have emerged in the operation of this tax.

FISCAL IMPORTANCE OF THE PROPERTY TAX

The place of the property tax in the scheme of state and local revenue sources is revealed by Table XXXVIII, based on census data.

TABLE XXXVIII
SOURCES OF TAX REVENUE FOR STATES AND THEIR SUBDIVISIONS, 1942 *
(THOUSANDS OF DOLLARS)

<i>Governmental Units</i>	<i>Property Taxes</i>	<i>All Other Taxes</i>	<i>Total Taxes</i>	<i>Ratio, Property Tax to Total Taxes</i>
State governments	271	4,704	4,925	5.4
Counties	897	37	934	96.0
Cities, towns, villages and boroughs	2,026	299	2,325	87.1
School districts	1,077	1	1,078	100.0
Townships	257	21	278	92.4
Other civil divisions	90	..	90	100.0
All governments	4,593	5,062	9,675	47.4

* Source: United States Census Bureau, *Governmental Finances in the United States*, 1942.

These figures emphasize the first characteristic of the property tax, which is that it provides virtually all of the tax revenue of the counties, school districts, and miscellaneous minor subdivisions, and almost seven-eighths of the tax revenue of the cities and towns. In the case of the states, which have developed and retained for state use other important forms of taxation, the property tax now provides only about 5 per cent of all tax revenues. The growth of other methods of taxation is a fairly recent development, which means that the fiscal importance of the property tax for state purposes was much greater a generation ago than it is today.

The significance of the local emphasis upon the property tax was brought out in the chapters dealing with public expenditure, where the lack of balance between the expenditure obligations and the revenue resources of local governmental units was emphasized. The subject must come up again in the discussion of local debts, for the maladjustment of resources, operating efficiency, and functional responsibilities has been an important factor in overloading these units with debt.

RISE AND DECLINE OF THE GENERAL PROPERTY TAX

A second characteristic of American property taxation has been the rise and decline of the so-called "general property tax." As the term implies, it was a tax on property in general, or on all property considered as a homogeneous whole. The theory underlying this method of property taxation was that all property of every description was to be taxed unless expressly exempted, and at rates that were to be uniform on all property within a given taxing district. Because of the emphasis upon uniformity in rate and in the basis of assessment, the general property tax was often referred to as the "uniform rule" of taxation.

Development under primitive economic conditions. The general property tax is best suited to a simple, undeveloped economic and social organization, in which there is comparatively little differentiation in the economic importance of the various kinds of property that are known and used. It appeared in various countries during the medieval period, and in the American colonies.¹ The details of its development in the early American period have been studied thoroughly for only a few states, but the general outline of the movement was probably much the same everywhere. The pioneer community did not usually begin with the general property tax, unless its settlement occurred so late in the nineteenth century that it borrowed, at the outset, many institutions including this tax, from older states. Such was the case with the states west of the Mississippi River. The older states began with a series of taxes on specific kinds of property, the kinds that were most prominent and important at the time. As the forms of wealth multiplied, the enumeration of the kinds of taxable property in the tax law grew, but only those forms that were expressly mentioned were taxed. Finally, the transition to a general property tax occurred when the procedure of the tax law was reversed and all property was declared to be taxable unless expressly mentioned as exempt. This stage was reached in Ohio, for example, in 1846, when a tax law was enacted which began as follows: "All property, real and personal, within this state, and all moneys and credits of persons residing therein, unless exempted, shall be subject to taxation." Six years later this method of property taxation was written into the Ohio constitution,

¹ Cf. E. R. A. Seligman, *Essays in Taxation*, 9th ed., Ch. II.

where it remained, despite upwards of a dozen vigorous campaigns for repeal, until 1929.

The taxation of all property without differentiation, at a uniform rate and on a uniform basis of valuation, was probably as reasonable and equitable a method of property taxation as could have been devised, for the pioneer communities in which this method developed. Such property as existed in these communities consisted, for the most part, of lands, buildings and other improvements to land, livestock, merchandise, various raw materials from the farm and the forest, and a limited amount of mercantile credits and other investment instruments. The bulk of this wealth was tangible and material. It could be seen and reasonably well appraised by the assessor. The defects of theory and administrative procedure to which this tax is subject became apparent, and eventually insuperable, with the transition from primitive to complicated methods of economic organization, and with the emergence of large amounts of corporate securities and other forms of intangible wealth.

The commercial activities of the New England colonies had produced a sufficient volume of mercantile credits and mortgage loans to give rise to some administrative difficulties, even prior to the Revolution. In the states west of the Appalachians, the conditions which made the general property tax unworkable did not come until after the middle of the nineteenth century. In Ohio, which may be taken as a typical example, although its general economic development was no doubt more advanced than that of the other states of the upper Mississippi Valley, there was, prior to the Civil War, no great amount of those forms of wealth that are the despair of the general property tax administrator. Thus, in 1820, there were but nineteen banks in the state, with a combined capital of \$1,697,463, circulation of \$1,203,869, deposits of \$454,452, and specie reserve of \$433,612. By 1846 there were thirty-four banks with an aggregate capital of \$5,825,677 and circulation of \$5,674,769. There were but four or five railroads open to traffic in 1850, with a total mileage of less than 300 miles. Aside from the banks and the transportation companies, there were practically no business corporations in the state in 1850.² The pack horse, the prairie schooner and the flat boat were still the important agencies of transportation. Industry was yet very largely in the domestic and handicraft stages. The modern large-scale organization of production was still a thing of the future, and the vast mass of intangible wealth in the form of corporation securities, bank deposits, promissory notes and other credits, while not unknown, existed only in comparatively negligible amounts.

The escape of intangible property. The test of the success and efficiency of the general property tax was in the completeness with which

² E. L. Bogart, *A Financial History of Ohio*, University of Illinois Studies in the Social Sciences, Vol. I, Nos. 1 and 2 (April, 1912).

all forms of taxable property were listed, and the accuracy with which they were appraised, on the basis of their market value. The growth of intangible property meant the increase of forms of wealth that could not be seen by the assessor. Its existence could not become known to him except with the help of the owner. Despite the use of elaborate personal property listing blanks, with a terrifying oath as to their correctness, and even the resort in some states to "tax ferreting," a kind of legalized underground investigation of personal affairs, the amounts of intangible wealth listed for taxation declined, both absolutely and relatively. The extensive reliance upon property taxation for state and local use after the Civil War caused property tax rates to advance, and the premium on successful evasion was thereby increased. A vicious circle of cause and effect operated. Rising tax rates stimulated evasion, and increasing evasion led to higher taxes on such property as was listed for taxation. The uniform rule was written into the constitutions of many states, and neither the legislatures nor the taxing officials of these states had any alternative except the imposition of the heavy current tax rates on such stocks, bonds, notes and credits as were discovered.

This situation was often accepted as a matter of course by the assessors, and the personal declaration of intangible property was regarded as no more compulsory than the "silver offering" collected in church. The affidavit of the taxpayer was so generally falsely sworn to that as early as 1872 David A. Wells said, referring to the situation in New York, that perjury, direct and constructive, had become so common as to cease to excite notice.

False swearing was not, however, the only way out. One avenue of escape has been investment in securities exempt from state and local taxation. Federal bonds have always enjoyed this immunity and practically every state has exempted its own bonds, as well as those of its subdivisions. In addition, every state exempted the stocks of domestic corporations, a privilege that gave to domestic stocks a market advantage within the state to which their investment merit often did not entitle them. Many thousands of dollars were sunk in worthless stocks on account of the local tax exemption which they carried.

Another method of escape open to the owner of large amounts of intangible wealth was migration into some state which was especially lenient toward such property. There the new citizen was permitted to make his own return, and thus to secure immunity in exchange for a declaration of such part of his holdings as he was willing to offer for taxation.

Instead of taking the trouble to leave the state, however, the owner of intangibles could establish a residence in some district in which the tax rate was low. More than one prosperous city dweller kept up the old home place in the country for other than strictly sentimental reasons.

Sometimes wealthy individuals would go to the seashore or the mountains, establish a small school district or a village, and make their personal property tax returns there. The cost of local government in such a district would be small, and the tax rate would be low in comparison with that of the larger cities.

The relinquishment of the principle of the general property tax came slowly, despite the mounting evidence of its inadequacy. Having been embedded in state constitutions, the task of constitutional change was extremely difficult. The belief that intangibles could be listed for taxation at the same rates that were levied on real estate died hard, although the assessment rolls provided abundant refutation of this notion, since they contained aggregates of intangible property that were ridiculously small in comparison with the amounts that were known to exist. In time, however, the necessary modifications were made in a number of states, and the door was thus opened for other methods of taxing this class of property. The form of the general property tax is still found in a few states, but it is everywhere regarded as obsolete.

Theoretical difficulties. The stubborn resistance to proposals to modify the general property tax, in the face of conclusive evidence of the impossibility of taxing all property, tangible and intangible, at the same rate, has been due to the widespread confusion that has prevailed with respect to the character of the various forms of property and their relation to each other. There has been a genuine conflict of viewpoints which have not been easily reconciled.

According to one viewpoint, the bulk of intangible property is simply "representative" property. That is, such things as corporation stocks and bonds, mortgage notes and mercantile credits, are simply titles to some sort of interest in physical wealth. A share of stock is the evidence of joint or undivided ownership in the net worth of the corporation. The stockholder does not own a fractional share of the land, buildings and machinery of the corporation; he merely has title to a certain equitable interest in the net assets, with a right to vote at shareholders' meetings and a right to dividends when declared and paid. The stock certificate represents these rights. The corporation bond represents various other rights and interests which the bondholder has with respect to the corporate property and income. Therefore, it is contended, if the physical property and business of the corporation are taxed, it is unnecessary to tax the instruments, such as stocks and bonds, which serve merely to apportion the equities and privileges of ownership, management and income among various groups. More than this, it is regarded as "double taxation" to tax both the physical assets of the corporation and the instruments which represent the various equitable interests in these assets.

The other viewpoint would grant the essential validity of the foregoing, but would regard much of it as immaterial. According to this

view, stocks, bonds, notes and other intangibles are, in law and in fact, property. Their representative character is minimized, and emphasis is laid on the fact that such instruments now constitute an important part of the wealth of individuals. They have market value, which is often substantial, the owners and the courts regard them as property, and they serve as the means of obtaining income from the productive activities of the community. The owner of stocks or bonds is held to be as truly a property owner as is the person who owns land.

There is an element of truth in each of these views. They conflict because they regard the same set of facts from different positions. The wide diffusion of intangible property and the existence of numerous taxing jurisdictions have intensified the conflict, while the rigidity of tax systems as well as of mental attitudes has delayed the attainment of reasonable and equitable solutions. Thus, there can be no denying that a considerable part of intangible wealth is merely representative wealth, deriving its value and its economic importance from the existence of the underlying physical wealth used in production and from the success of that use. It does not follow, however, that taxation of the physical assets of the corporation where they are located always constitutes adequate taxation of the representative wealth. This position assumes that the taxes on the property of the corporation always fall on the holders of its securities, but such a position is in large degree untenable. For example, the interest rate paid on corporation bonds is governed by the conditions of the general money market at the time of issue. Likewise, the dividend rate on corporate preferred stocks is established more or less by custom and by the general investment attitude toward this type of security. The rates of return that are paid by the corporation on its bonds and on its preferred stocks are not affected by the property taxes paid by the company unless these become so heavy as to threaten insolvency. Consequently, neither the bondholder nor the preferred stockholder is taxed or otherwise inconvenienced by the taxation of the corporate property. The common stockholder, being the residual claimant to the corporate net income, is the only owner of corporate representative wealth for whom a true case of double taxation can be made.

The existence of numerous taxing jurisdictions has intensified the demand for the recognition of intangibles as property for the purposes of taxation. The physical wealth may be located in one tax district and taxed there, while the owner of intangibles may live in another district, where his holdings of stocks, bonds or mortgages give him the standing that is enjoyed by the owner of any other kind of property. It is impossible to convince the owner of land or merchandise in the district in which the holder of intangible property lives that such forms of wealth should not be taxed because of their representative character.

From a pragmatic viewpoint it may be said that the indifferent results

which characterized the efforts to tax intangible wealth were not wholly bad or unfortunate. At any rate, there was a bright side to the picture. Investments in intangible property, particularly corporation securities, have been the means by which funds have been provided for the maintenance and expansion of industry. The country has needed a large flow of venture capital, and its economic growth is the evidence of the benefits produced by this type of investment.

A more rigidly enforced tax system would no doubt have satisfied better the requirements of some theoretical standard of tax perfection, but it might also have restricted the flow of capital investment by impairing the incentives which stimulate that flow. The easy-going treatment of intangibles by assessors generally may have borne fruit in a growth of physical assets, volume of business, employment opportunities, and pay-rolls, at a rate greater than would have occurred had there been an unyielding enforcement of some abstract principle of tax justice.

A further pragmatic consideration today is the enormous weight of the federal income tax, which is so great as to offset any degree of laxity that may be displayed by local assessors. This tax has destroyed and is destroying the value of property, both real and personal. It destroys the value of intangible property by its deep inroads upon corporation earnings and by confiscating a substantial proportion of such income on security investments as may be received by the individual. It destroys the value of real property by this same process of wiping out the incomes of the owners of such property. It is true that taxes on property are deductible from gross income, but this does not mitigate the fact that so much of the owner's net income is taken by the steeply progressive taxes as to render the taxpayer both unwilling and incapable to set the same value on a piece of property, whether for business or residential use, as he would consider if more of his income were available for his own use. The shrinkage of values thus produced compels the levy of higher tax rates on all property, thereby adding to the tax load of property owners regardless of how they may be affected individually by the federal tax.³

EMERGENCE OF PROPERTY CLASSIFICATION

The next characteristic of American property taxation to be noted is the emergence of various schemes of property classification. This movement has been complementary to the decline of the general property tax, and the developments in this direction have served to register the decline and collapse of the uniform rule. Classification, as used here, means the creation of classes of property, each of which is to be dealt with in some manner separately from other classes in determining the taxes to be

³ Cf. *Town of Montclair, New Jersey, A Study of Municipal Finance and Service*, by The Princeton Surveys, 1942.

imposed. In some cases different rates were fixed, while in other cases the assessment of each class was to be at some specified percentage of the true value of the property in this class.

The most generally observed classification of property for taxation has been that between tangible and intangible property. Naturally, the establishment of intangibles as a class of property to be dealt with in a manner different from other property was the signal or evidence of the abandonment of the idea of general property taxation. Some states have carried the scheme of property classification much further, by setting up various groups of tangible property, real and personal. One of the most comprehensive of these systems of property classification is that established in Minnesota in 1911, under which the following classes are now distinguished:

Class 1. Iron ore, whether mined or unmined, assessed at 50 per cent of full value; if unmined, it shall be assessed as part of the real estate, but the separate value of the land shall be assessed according to Classes 3, 3b, or 4 as the case may be.

Class 2. Household goods and furniture, wearing apparel and all personal property actually used for personal and domestic purposes, assessed at 25 per cent of full value. An act of 1935 exempted "all household goods" and permitted a \$25 exemption against the other property in this class. (Chap. 385, Laws of 1935).

Class 3. Agricultural products (except as provided by class 3a) merchandise and store fixtures, manufacturers' material and supplies, all tools, implements and machinery whether fixtures or not (except as provided by class 3a) and all unplatted real estate (except as provided by class 3b), assessed at 33⅓ per cent of full value. The act of 1935 exempted all farm machinery except tractors, silo cutters, threshing machines, corn shellers and pea viners.

Class 3a. All agricultural products in the hands of producers, assessed at 10 per cent of full value.

Class 3b. All unplatted real estate except as provided by class 1, and which is used for the purposes of a homestead, assessed at 20 per cent of full value. If the true value exceeds \$4,000, the excess shall be assessed as in class 3.

Class 3c. Platted lands used for purposes of a homestead, first \$4,000 of value 25 per cent; remainder of value, 40 per cent.

Class 3d. Livestock, poultry, horses, mules, asses, tools, machinery, used by owners in agricultural pursuits, assessed at 20 per cent.

Class 4. All property not included in the foregoing classes, assessed at 40 per cent of true value. The most important form of property in this class is platted city real estate.

ASSESSMENT ON CAPITAL VALUE

American property taxation has always been based on the capital or selling value of the property taxed. An alternative method, which would be more appropriate for real estate than for some kinds of personal property, would be assessment on the annual income value, which is the basis of land assessment in England and on the continent of Europe. This con-

trast in assessment methods between the Old World and the New has a valid historical basis. It goes back to the relative land scarcity in Europe, and the relative abundance of land in the period of American settlement. The consequence of land scarcity in Europe was that land was never sold, except under pressure of sheerest necessity. On the contrary it was kept in the family for generations, being subdivided among the successive heirs until further parcelization became impossible. In the absence of a free land market, the important aspect of land was not its capital value, but its current use or income value. The reluctance to sell gave rise to an extensive leasing system, which tended further to emphasize the income rather than the capital value.

In this country, at the time the property tax was developing, land was over-abundant. In fact, just beyond the frontier it was a free good. Under such conditions land hunger was impossible, and everyone was ready to sell his farm or his city lots, since others could be easily acquired by purchase or simply by moving westward. The products of the soil were abundant and cheap, and there was more interest in land speculation than in its current productive use. The American tax laws naturally selected the salient feature of the American land system, which was freedom of sale and the capital values established in a free land market, just as the English and European tax laws selected the outstanding feature of the Old World land system, which was the annual income, as set by current use and by the leasing system.

The theory of a free market in which property values are established was naturally extended to other forms of property as these were brought under the property tax, and thus assessment on the selling values as reflected by market transactions became the universal rule of American property taxation. The assumption of a broad, free market for all kinds of taxable property was valid, being based on general experience, during the period in which the property tax was developing. Constitutional and statutory phraseology relating to this tax incorporated the free market concept, and the standard of valuation prescribed was always expressed in terms that implied the existence and efficient functioning of such a market. Property was to be assessed at its "fair market value," or at its "full cash value," or at its "true value in money." These and similar expressions were always defined and interpreted as the price that would be agreed upon by a willing buyer and a willing seller, that is, the price established in a voluntary sale, with no compulsion on either party, whether in buying or in selling.

This concept is still dominant in the operation of the property tax, and in the attitude of courts and administrators. Tax laws still require assessment at the market value, although it is no longer true that a free market exists for all units of property. Many large property aggregates are no longer bought and sold with sufficient freedom and regularity to

establish a market. The growth of corporate ownership and the relative permanence of corporate existence and management, have materially altered the situation. Steel mills, railroad lines, electric generating and transmission systems, great office buildings, and steamships are not freely bought and sold today. Even in the case of ordinary real estate, there are marked variations in the volume of transfers, depending on the course of the business cycle, the outlook for agriculture, and the migratory movements of the population. Large and small land booms still occur, and as regularly collapse. The speculative attitude toward land ownership persists, although the market thus established becomes increasingly unreliable as a guide to the assessor. No more important problem of property taxation exists than that of finding a defensible technique of assessment in the face of these changing conditions, but the further discussion of this subject belongs in the next chapter.

Development of "in lieu" taxes. There has been some adjustment to the changing conditions referred to in the preceding paragraphs, by the development of taxes based on some other characteristic than the capital value of the property. Such taxes are regarded, in theory, as taxes on the property, but they are levied on some other base, usually the gross earnings. Hence they are described as being "in lieu" of taxation of the property as such. The motive for their use has not always been conscious recognition of the disappearance of a free market for such properties, but rather the avoidance of the administrative difficulties encountered in the assessment process. This substitution has been made, for example, for railroads in Maine and Minnesota, and for certain public utilities in New Jersey. States using the gross earnings base in lieu of the property base are able to apportion to themselves a share of the gross earnings from interstate business, on a mileage or other equitable basis, without being subject to the restrictions ordinarily imposed on the taxation of interstate commerce. Various types of transportation company, such as the car and equipment companies and the express agencies are quite generally taxed on a gross earnings basis, since the value of the property used in any state is such a variable quantity in view of the character of the business.

DEVELOPMENT OF CENTRALIZED ADMINISTRATION

The main outlines of the administrative changes that occurred in the operation of the property tax have already been given.⁴ Beginning with the equalization of assessments, the centralizing movement extended next to the assessment of public utility properties, and finally, with the appearance of the state tax commissions, to the supervision of local assessments of other property. In theory, the supervisory activities of a state body should lead to material improvement in the accuracy and uniformity of

⁴ See Chapter XIX.

the local assessments, but in practice much depends on the vigor and alertness of the supervising agency, and on skill in securing the coöperation of the local officials.

The early achievements of some of the capable tax commissions were notable in these respects. Never before had there been state-wide contact with all assessors, accomplished through correspondence, issue of a manual of assessment and other instructions, field visits and regional conferences. For the first time, under the leadership of the tax commissions, assessors were given advice, instructions, criticism, and in general, some preparation and equipment for their work. These activities effected some coordination where none had ever existed before in the operation of the property tax, and in some degree they were successful in substituting general observance of proper assessment standards for the policy of competitive undervaluation that had so commonly vitiated the earlier assessment practices.

The relatively high level of assessment uniformity for tangible property that was achieved by some tax commissions at the outset has not since been maintained in all cases. Routine methods of supervision were established and presently became inflexible. Political and other influences undermined the vigor and authority of the commissions, and as the novelty of the relationship between commission and assessors wore off, there was some relapse toward the earlier assessment conditions.

Property assessment supervision in Wisconsin. The ultimate resort, in controlling the local assessment results, is reassessment, made either by the incumbent assessors or by others drafted by the tax commission for the purpose. But the wise exercise of this authority depends on the accumulation of clear evidence of the necessity, a matter which is not easy at long range. The weakest point in the otherwise excellent idea of central supervision of local assessors is the remoteness of the tax commission from the local districts in which the assessors work. Only two states, Maryland and Wisconsin, have undertaken to meet this difficulty and the solution that has been developed, particularly in Wisconsin, deserves general consideration. It is the creation of property assessment supervision districts, each in charge of a supervisor of assessments, appointed and controlled by the tax commission.

Originally, each county was such a district, and with the enactment of the state income tax law, in 1911, the assessor of incomes was made, ex officio, the supervisor of assessments. This merger of functions covering two such widely different fields as income and property tax administration did not prove entirely satisfactory, and they were later separated.

The property supervision districts include from three to eleven counties,⁵ and the several supervisors, enjoying long tenure under civil service, devote full time to the study of conditions relating to property values in

⁵ Cf. the account of the functions and services of the Wisconsin supervisor of assessments by H. L. Lutz, in *The System of Taxation in Maine* (1934), pp. 36-45.

their respective districts. Thus they acquire an intimate familiarity with the character of the taxable property which enables them to judge with fair accuracy the quality of the assessments being made. They are liaison officials between the commission and the assessors. Upon them falls the primary responsibility for instructing and guiding the assessors, a substantial proportion of whom each year have had little or no previous experience. They conduct short training sessions or conferences before the field work begins, and they follow closely the operations of the several assessors during the assessment season. Through them sales data, property quotations, and similar pertinent information are transmitted to the assessors, together with the rulings and instructions of the tax commission. When the district board of review and equalization meets to pass on the assessor's results, the supervisor is present, and he may function before this meeting either as a critic or a supporter of the district assessment.

Another useful service of the Wisconsin supervisor of assessments is the independent study that he makes of property values, as a basis for the state equalization and the determination, by the tax commission, of the true value of property throughout the state, an aggregate used in calculating the average rate of property taxation. Since this average rate is used in determining the taxes to be paid by the railroads, much depends on the supervisors' findings and conclusions with respect to property valuation.⁶

The device that has proved so successful and satisfactory in Wisconsin would, if generally adopted, provide a solution of more than one administrative difficulty that has hitherto proved troublesome. In the first place, it would, in effect, bring the tax commission much closer to the assessors and thereby give greater vitality to the whole supervision process. In the second place, it would in large measure overcome the handicap imposed by the large number of small assessment districts and the stubborn resistance displayed toward the creation of larger districts. In so far as progress may eventually be made in the reconstruction of local government, as urged in an earlier chapter,⁷ the problem of suitable assessment districts will be solved along with other problems.

The larger municipalities contain enough property to warrant the provision of a fully equipped assessor's office, with high grade personnel.

⁶ In Maryland there is a supervisor of assessments for each county and the City of Baltimore. They are appointed by the tax commission, hold office during good behavior, and are removable at any time by the commission for incompetency or cause. Their duties include. (a) supervision of local assessors; (b) appeal to the tax commission from the action of assessors in matters of assessment; (c) study of local property values through visits and sales information, (d) recommendation of increases or decreases to assessment to the assessors and other assistance. Cf. Maryland Tax Commission, *Report*, 1929, p. 6.

⁷ Cf. Chapter VII.

Proposals have been made to create larger assessment districts by substituting counties for towns or townships. So far as rural and village property is concerned, the Wisconsin alternative is probably less costly, and it may be as satisfactory from the standpoint of results. The experience there indicates that the supervisor is able to contribute to the quality of assessment results even in the larger cities, notwithstanding the superior personnel of the municipal assessment organization. One reason for this is that the supervisors have been carefully selected from the cream of the assessors, as a promotion for efficient service, and they are thus able to approach their supervisory duties with an ample background of experience regarding the matters in which they must instruct, guide and criticize others.

FISCAL INADEQUACY

Under normal conditions the owners of property can and do pay the taxes levied on their property with reasonable promptitude. These taxes come out of the income from the property if it is held or used for business or other income-producing operations. In the case of residences occupied by the owners, the property taxes must be paid out of other income. Any circumstance that impairs seriously the income from the property or the general income of the owner tends to cause an increase of property tax delinquency and thus to impair the tax as a dependable source of public revenue. While various influences may operate thus unfavorably, three factors of general significance may be noted. These are:

1. The severity of federal income taxation, referred to above;
2. An unbalanced ratio of population to land;
3. Widespread economic depression.

The population ratio. The term *population ratio* is used here in a suggestive rather than an exact sense. It is intended to bring out a phenomenon which has become increasingly apparent but which has not, as yet, been subjected to careful analysis, namely, that land values are impaired, both when there are too many, and when there are too few, people located in a given area.

Thus, it is a well-known fact that every large city has its dead spots, its blighted areas. This is, essentially, a question of physics and mechanics. As the population of a city increases, freedom of access to its center is diminished, despite improvements in transportation. On the other hand, those same improvements increase the freedom of movement toward and around the periphery. The more compact is the city's design, the worse becomes the central congestion with continued growth, and the stronger

are the centrifugal forces. Land values at the center, or in some parts of the central area, are depreciated because of the sheer inability to maintain the volume of business there that would sustain a high value. No one can observe the traffic jams that are a regular feature of the central streets of any large city and fail to realize the enormous addition to business costs that must be involved.

A great city is like the cross-section of a tree. In the tree the sap travels through and just under the bark. As the diameter of the tree expands, the sap encounters greater difficulty in permeating to the center and presently the heart of the tree dies for lack of nourishment. Similarly, the most vital part of a large city, economically, tends to be the periphery. Like the tree, portions of its center die for want of an adequate circulation of economic life blood.

Instead of trying to resist this principle of nature, it would appear be wiser long-range policy to accept and conform to it. Resistance is likely to take the form of subsidies, either to rebuilding projects or to transportation. A better way of adjustment would be to recognize that the blighted areas had lost their economic usefulness for the accustomed purposes and that they should be converted to other uses, such as parks, vehicle parking places, wider thoroughfares, and so on. This loosening-up process will dissolve the congestion, provide channels for a freer circulation of the lifeblood of commerce, and preserve, even enhance, the values of the remaining property. The acquisition of the necessary property for such purposes, through condemnation, would be at prices based on the depressed future of that property under the existing conditions. The cost of such changes may properly be viewed as an alternative to the subsidies which are likely otherwise to be poured into the blighted areas.

This proposal looks toward the establishment of conditions under which the property values of metropolitan areas may be immunized against economic blight. Given a careful and logical plan for the excision of the worst spots and sections, greater stability of earning power will be assured to the other property, and thus there will be greater steadiness and dependability of the property tax revenues.

At the other end of the scale are the areas and regions which are of very low value for lack of people. It is unnecessary to consider here whether the people stay away because the land is poor, or whether the land is poor because the people do not come and develop it. The cause may be one or other of these factors. The result is the same, namely, that little or no tax can be collected under the levies on such land.

The remedy would appear to be, in this case, not the transfer of more settlers to it but the elimination of the forms and structure of local government which would be appropriate only if there were present a substantial degree of productivity. The de-organization of government over this type of blighted area has only begun. It should be considered

and applied for many sections which are today simply a drain on other taxpayers.⁸

Widespread economic depression. The experience with property tax collections during the depression years after 1929 revealed the impossibility of resisting wholesale, and in some cases organized delinquency. Such behavior had never been previously encountered; indeed, the possibility had never before been suspected. On the contrary, the earlier belief had been that this tax was a fairly dependable source of revenue under all circumstances. Nothing had occurred during earlier depressions to disturb that belief, which was further strengthened by the faith in the efficacy of the ultimate extreme resort to enforce collections, namely the tax sale.

The phenomenon was similar in its manifestations, and perhaps in its origins, to some other aspects of the "debtors' revolt" during these years. Lenders on mortgage security believed that they had little to fear from depression, since their legal right of foreclosure was assumed to be adequate ultimate protection; but the peculiar brand of mob psychology aroused by the depression led to armed resistance against mortgage foreclosure proceedings in many places, and finally to extensive debt moratoria by statute. Local governments evidently assumed, likewise, that the procedure of tax collection was sufficient to assure a substantial flow of revenue, and in any event, under the typical structure of the local revenue system, they had no option but to continue the property tax levies. The taxpayers' resistance was, in general, passive, although there was much talk, and some demonstration of "taxpayers' strikes." In some states legislatures enacted ill-considered moratoria on tax sales, and on other steps to enforce collection. Some of these laws made deliberate and wilful property tax delinquency so attractive that it was remarkable to find any taxes being paid.

Causes of the collapse. This breakdown of the property tax was the harvest of much diligent sowing by several groups of husbandmen. The depression did not create the problem. It was merely the signal that the time had arrived to garner the fruits that had been planted with such zeal, just as it was a harvest-time for the results of the earlier stupidity in banking, in mortgage lending, and in other fields. The character of the sowing that was to produce this crop in the case of the property tax may be briefly indicated.

Faulty assessment procedure. As noted above, long-range supervision of assessments has been a matter of considerable difficulty. Irregular and unequal assessments naturally occur, especially in the absence of any effective coördinating and equalizing influences. Some properties were no doubt assessed at levels on which payment of the taxes levied was burdensome in normal times, and impossible under depression conditions. Entire

⁸ Cf. W. S. Carpenter, *Problems in Service Levels* (1940).

tax districts may have been thus over-assessed, although the over-assessment of a whole district, in itself, should not have been a cause of excessive taxation unless there were heavy taxes on property for county or state use. So far as the district tax burden is concerned, a high level of assessment should mean a correspondingly low rate of property tax. The relatively high assessment would, however, tend to stimulate expenditures, through the creation of a false sense of local taxable capacity, and it would also encourage local borrowing if the debt limit were based on assessed values. Thus the tax burden would be eventually increased.

Uncontrolled expenditure. The ultimate cause of the tax burden is, of course, the expenditures that are budgeted. The years prior to the depression were years of rapidly mounting public expenditures, and consequently, of rapidly rising tax rates. Nothing of importance was being done during these years to establish effective expenditure controls, or to check in any way the growth of public expenditures. The fiscal breakdown that came with the depression was the precipice toward which all governments had been rushing headlong for years, and over which they finally plunged.

Over-development of real estate. It is a well-established fact that real estate, as a field of investment, had suffered from cut-throat competition for years prior to the depression. In Cook County, Illinois, more land had been platted and subdivided by 1930 than could have been occupied by 1960, at any reasonable estimate of population growth in the Chicago area. Detailed studies of tax delinquency in some cities indicate that it was most serious in the overambitious developments which had, at best, only a very remote prospect of ever being occupied. In all such cases, the special assessments for street improvements were as much, or even more responsible than the ordinary property tax levies for the delinquency. In every large urban area, from New York City down, there had been furious over-construction of hotels, office buildings, and other structures, which had largely destroyed the earning power of all such properties before there was any hint of a depression. In the agricultural areas there had been ruthless destruction of forests, thickets, and natural grass lands in the insane effort to add to the tillable area, so that in agriculture as in urban real estate, the ability to pay taxes on property, or even to make a living on it, had been seriously impaired by competitive throat-cutting.

The maladjustments of local function and resources. This subject has already been discussed. In the present connection it should be emphasized that local governmental units have been overburdened with functional responsibilities, while they have been forced to depend for revenue almost entirely on the property tax, thereby increasing the tax load on property and the seriousness, from the standpoint of the maintenance of essential governmental services, of the collapse of this tax. The effectiveness of state subsidy systems in relieving the property tax has been lessened by the

perpetuation of the relative inefficiency of the existing local governmental structure and functional distribution. Consequently, the state aids could neither prevent the breakdown nor adequately mitigate its consequences.

Improperly controlled local borrowing. The years prior to the depression of 1929 had witnessed in some states the creation of an inordinate volume of local debt, the taxes for which naturally fell almost wholly on property. While local debt limitations of some kind existed in virtually every state, they were either too liberal or too easily avoided by exceptions of various sorts, to operate effectively as a restraint on the inclination to borrow. The consequences of an improperly controlled growth of local debt were especially severe in the depression years after 1929. In 1932 the net debt (gross debt less sinking fund assets) of all local subdivisions was \$15,216 million, on which the aggregate interest payments were \$732 million, or 16.7 per cent of all local property tax revenues. Ten years later, in 1942, the situation had been materially improved, both through reduction of debt and through favorable refunding into lower interest rates. Net local debt then totalled \$13,494 million, on which the interest payments were \$420 million, or 9.7 per cent of total property tax receipts.

A weak collection system. The collection of property taxes is everywhere a local responsibility, over which there is, with few exceptions, no sort of supervision either by state or by other local officials. The collector's only resort, when property taxes are not voluntarily paid, is to report the delinquency and eventually to take the steps required for holding a tax sale. At best this procedure is a rather empty formality, since the courts have been disposed to protect the delinquent owner and to restrict as much as possible the final transfer of title by this process. In theory the purpose of the tax sale is to effect a transfer of the property from the person who is presumably not capable of using or managing it with sufficient success to pay the taxes to someone who is more competent. In practice, the purchaser at a tax sale is regarded by the courts as an intruder, and they resist strongly any loss or destruction of the former owner's equity.

Notwithstanding these barriers, the tax sale is useful as a penalty, since it registers the tax claim and imposes definite additional burdens in order to effect redemption. But its usefulness for this purpose exists only when delinquency is the exception, and it becomes entirely futile when taxes are in default on thousands of parcels, since there is obviously no bona fide market under such conditions, and the only result is to pile up penalties on a tax load which cannot itself be carried. The great mass of such property will be sold to the city or to the state (some tax laws vest the tax title in the city, others in the state) but this formality evidently can produce little cash, except as it may stimulate some to pay their taxes who had deliberately defaulted, and who elect to pay rather than incur the added penalties involved in redemption.

TYPICAL STRUCTURE OF THE PROPERTY TAX

On account of the many local variations, the outline of a typical property tax must be general in form, but it is possible to present in this way the chief characteristics of the property tax structure.

Property subject to taxation. Two general classes of property are reorganized, namely real and personal property. The first includes land and the improvements that are permanently attached thereto. The second includes all movable property. Buildings are classed as real property, since they were considered to be immovably attached to the land during the centuries in which the legal distinction between movable and immovable property was developing. Modern engineering has found ways of moving large buildings without interrupting sanitary, telephone or other services, but they are still classed as real property. The property of public service corporations is sometimes classed as personal, and in other instances as real, property.

The exemption policy of the states varies greatly, and in general is too liberal. For the most important exemptions, the basis is the character of the ownership and use, rather than the nature of the property itself. Thus, property, both real and personal, owned by government, and that devoted to religious, educational and philanthropic purposes, is always exempted. Numerous exemptions to individuals are also found. Usually these take the form of specific deductions from the total assessed value, although some states expressly exempt a certain value of real property under a so-called "homestead" exemption. Mechanic's tools and some forms of personal property, such as young livestock, household goods and personal effects, are also frequently mentioned. New York has gone farther than any other state in the exemption of all forms of personal property.

To whom assessed. The correct method of assessment of real property is *in rem*, that is, on the thing itself without regard to the fact of ownership. Personal property is always assessed to the owner, although with respect to such property, objectivity in appraisal is quite as important as it is in the case of real estate. That is, the personal status of the owner, his political or personal attitude toward the assessor, and other matters of this sort are supposed to be eliminated in making all assessments, so far as this is humanly possible.

Place and date of assessment. Real property is always assessed in the district in which it is located, regardless of the owner's residence. Some forms of tangible personal property are also assessed at their location, such as the machinery of manufacturing corporations in Massachusetts, livestock in the grazing states of the West, and logs and lumber in Washington.

Aside from these and similar exceptions, the general rule is that personal property shall be assessed in the district in which the owner resides.

Under the general property tax, intangibles, which have no fixed or definite location, were always assessed at the residence of the owner.

Tax laws usually specify a fixed date, as of which the valuation of property is to be made, although the assessor cannot actually complete his task of listing and appraising all property in the district on this date. The date chosen may be at a time of the year when rural assessors have greatest freedom for doing this work, which would be early spring or late autumn. Frequently it has no proper relation to the local fiscal year, which means that local governments are obliged to borrow in anticipation of tax receipts that may not come in until near the close of the fiscal year for which they are levied.

Personal property is always assessed annually, and for stocks of merchandise the average inventory value for the year is sometimes made the basis of the assessment rather than the actual stock on hand on a given date. Real property may be assessed at regular, periodic intervals, or at infrequent and irregular intervals.

Basis and method of the tax levy. As already indicated, all property is taxed, under the property tax, on its value in money. Some states provide that the tax shall be levied on a certain percentage of the full or true value, which is a method of legalizing a degree of general undervaluation that had become customary in making assessments. Whether the tax is computed on full value or on some fixed percentage of full value should make little difference in the total taxes to be paid or in their distribution among taxpayers. The community will be accustomed to one level of taxes if full values are used, and to another level if some percentage of full value is used. High tax rates are popularly regarded as a psychological restriction on expenditures, and many therefore favor deliberate undervaluation for this reason. The reasoning is childish and the results of such a policy are seldom satisfactory, from the standpoint of expenditure control. It is true that if general undervaluation has been practiced for a long period, various other things are eventually associated with the assessment level, such as local debt limits and statutory tax levies for specific purposes such as schools, libraries or parks. A sudden transition to a higher ratio of assessed to true value under such circumstances would be disturbing.

The use of a depreciated valuation basis, as 25 or 50 per cent of true value, does not make the assessor's work easier for he must in every case determine the true value before he can compute the statutory percentage thereof on which the taxes are to be determined. The assessment roll should contain a column for the true value and another for the entry of the statutory percentage value on which the taxes are to be computed, if this practice is followed.

The rate of tax may be set or limited by statute, or it may be determined by the relation between the assessment total for the district and the amount budgeted to be raised under this tax. The state property tax,

where used, is usually levied at a definite rate, but in Massachusetts the legislature enacts that a fixed sum shall be raised in this way. Each city and town provides its quota by an appropriate addition to the local tax rate. Local property tax rates are usually determined by the local budget requirements, although in some instances, notably Minneapolis, a series of specific rates of levy for the various services is authorized. This method complicates the local budgeting process, since it prevents transfers and provides an incentive for each service to spend the full amount which it is authorized to levy.

The tax rate is commonly expressed in mills per dollar of valuation. A levy of ten mills would be one cent per dollar, or a tax rate of one per cent.

Administrative officers and procedure. It is evident that the task of securing annually a list of each person's property, combining the totals, correcting and equalizing the returns in order to effect an equitable assessment for the district and among the different districts, computing the taxes due on each parcel of property, preparing tax bills and collecting the tax, is one that will require a considerable administrative organization for its successful performance. More than this, it will demand effective coordination of parts if the result is to be reasonably equitable. No small share of the work of such officials as the county auditor and the county treasurer is taken up with certain phases of this task of assessing and collecting the taxes. Certain other officials are also required, the more important of whom are the following:

The assessor. This officer is charged with the duty of listing the various forms of taxable property in his district, appraising each sort according to the standards laid down in the tax law, and making the formal assessment of it for taxation. Some states put the entire burden of listing and appraising on the assessor, while others require the owner to supply information as to value, or to submit a valuation which the assessor may accept or modify.

The method of selecting assessors varies in different states. The general rule is that of local election, but in some of the larger cities the assessor is appointed. The assessment district is the municipality in the states that have patterned their local government on the model of the New England town, while the county is the unit in the states of the south and west. Ohio has recently made the county auditor the assessor for the county, *ex officio*.

Boards of review. The returns made by individuals are assembled by districts, in an assessment roll or in some more informal and irregular manner, and are then submitted to a board of review, which is supposed to conduct hearings, listen to appeals and statements by aggrieved property owners, and perhaps make some investigation of conditions, whereupon it will order such changes and corrections in individual assessments as will,

in its opinion, result in a more uniform assessment of property throughout the district. The jurisdiction of the local boards of review may be the city or town, or it may be the county. A state equalization then follows, especially if a state tax is to be levied on property. Ordinarily this is confined to adjustments in the aggregate among districts, with a view to effecting a more equitable distribution of the state tax and to counteract any local tendency to district undervaluation for the purpose of escaping this tax. Some of the tax commissions have broader equalization powers, which include reassessment of parcels or classes of property when shown to be necessary by the evidence.

The tax collector. The final stage of the operation of the property tax is its collection. Collectors may be elected or appointed. While they are required to give bond to make more certain their faithful accounting for all moneys handled, their operations as collectors are not usually subject to any supervision or oversight. Accordingly, the vigor and impartiality with which they discharge this important duty is largely a matter for the individual to determine, and they are relatively free to dispense both favors and discriminations. The collector cannot, of course, remit the taxes of his friends, but he can, and too often does, delay tax sale proceedings in some cases.

CHAPTER XXIV

Problems of Property Taxation

THE REVIEW of some outstanding characteristics of the property tax in this country, presented in the preceding chapter, should be followed by an examination of some of the problems of theory and policy which this tax presents. In the present chapter some of the more important of these problems will be set forth; but, since the issues to be dealt with are in the nature of problems, no pretense can be made of providing, in all cases, a final solution. In some degree, the discussion will include examination of solutions that have already been proposed.

ASSESSMENT ON CAPITAL OR ANNUAL INCOME VALUES

The basis of property taxation, whether on capital or on annual income value, is not the first problem, in point of relative importance; but it logically demands consideration in advance of various other matters that would be affected by the decision reached on this subject.

As indicated in the preceding chapter, assessment on the capital value is firmly established here, both by long historical precedent and by developed legal sanctions. Many state constitutions require assessment on capital value. More than this, the whole local financial framework is built on it. Local debt limits, local millage levies for specific services, and in some cases, overall tax rate limits for all services, are determined with reference to this basis. A tremendous amount of re-designing would be required if a transition to the annual income basis were to be undertaken. Nevertheless, there is more or less ferment of discussion, and a continued undertone of advocacy of this method in preference to that now established.

Aside from the itch for change, the notion that "other pastures are greener," since it is found in England and on the continent of Europe, two serious arguments for the change have been advanced. These are: (1) that it would solve some difficulties of assessment now encountered in the determination of capital values; and (2) that it would therefore result in more equitable assessments among property owners. It is understood that the method is applicable only in the case of real property, and possibly, some extremely durable forms of personal property.

The first position is not well-founded. It assumes that the determination of income is a simple matter, whereas it turns out to be an extremely complicated one, even under income tax laws. Furthermore, use of an income value would not provide escape from valuation problems for the determination of net income compels resort to capital value determination. Allowances for depreciation, obsolescence and similar claims must refer to a capital value that is being impaired.¹ The proposed substitution of annual income value would not wholly eliminate the necessity for capital valuations, and it would introduce technical and administrative difficulties fully as complicated as any now encountered in capital value assessments.

The determination of annual value in England is not always by definite income accounting methods. The rating officer relies extensively on purely arbitrary factors which are obviously established on the basis of judgment. For example, a motion picture theater is rated at so much per seat. The different floors of office buildings and banks are rated at so much per square foot of floor space. Location is always considered in fixing these factors. In short, the rationalizing process is much the same in England as it is in the United States. There the question is: What figure represents, in the judgment of the assessing officer, a fair basis of annual income value? Here the question is: What figure represents a fair selling value? In England, the assessor guesses at what a residence occupied by the owner would rent for; here, he guesses at the amount for which the property would sell.

The argument for greater equity in the results rests on the doctrine that since taxes are paid out of income their amount can be more equitably determined by direct reference to the annual income than by reference to a capital value which is often imputed. But, as is shown above, there is about the same degree of guesswork, and hence about the same degree of error, in each method.

Bastable discusses the two most feasible alternatives for determining the assessable "annual income value." If most of the land is rented, the rentals would serve as a basis, and also as a guide for imputing the annual income value of lands occupied by the owners. If the proportion of ownership is large, the elaborate physical and economic survey known as the *cadastre* would probably be required. This involves, on the economic side, estimates of product, prices and production costs, and thus a considerable amount of official judgment, the very element to which objection is made in capital value assessments.²

For the present, on the ground of experience and the severely practical

¹ Cf. R. G. Blakey, "Simplification of the Federal Income Tax," *American Economic Review, Supplement*, Vol. XXVIII, March, 1928, pp. 102-118, especially p. 106.

² C. F. Bastable, *Public Finance*, pp. 428-431. Also, M. M. Daugherty, "Eighty-seven Years Experience in Taxing Land on Its Annual Yield Basis," *Bulletin of the National Tax Association*, Vol. XX, February, 1935, pp. 145-147.

considerations involved, it appears that the use of the annual income value is out of the question. The subsequent discussion of administrative and other problems will assume, therefore, the continuance of the capital value basis of property taxation in the United States.

THE ESTABLISHMENT OF APPROPRIATE PROPERTY CLASSES

A problem that has been forcing itself upon the attention of students and tax administrators, since the earliest evidences appeared of the disintegration of the general property tax, is the establishment of appropriate classes of property for tax purposes. If all property is not to be taxed as a homogeneous mass, at a uniform rate according to its value, obviously an alternative is to break the whole mass up into classes or divisions. This tendency has been under way for a long time, and the "classification" movement, so-called, has gained recognition as a prominent platform of property tax reform and improvement.

In the sense used here, classification means the establishment of various groups or classes of property, each of which is to be taxed on its value at a distinctive, effective rate.³ The essential problem involved is that of finding a defensible and dependable guide or rule for determining the number and the content of the several classes of property and for the selection of the distinctive tax rates to be applied to each.

Two general viewpoints may be recognized, as illustrated by the legislation that has been enacted. One viewpoint would create only a limited number of classes, the most conservative policy being simply the differentiation of intangible personal property for taxation at a rate lower than that imposed on all tangible property. The Maine constitution authorizes property classification to this extent, and some other states, notably Connecticut and Maryland, have gone no further. The other viewpoint would extend the classification idea to tangible property and would create various classes, both of real and of tangible personal property.

The case for the most limited, and in a sense the most elementary application of the classification idea, namely, the segregation of intangibles from other property and the taxation of this class at a lower rate than applies generally, has already been indicated in the preceding chapter. It is, without doubt, the most important single step that can and should be taken toward the solution of the difficulties of property taxation. But beyond this point, no clear, convincing philosophy of property taxation has as yet been stated whereby the issues involved in differentiating other classes of property might be satisfactorily settled.

The closest approach to such a philosophy is the position taken in the National Tax Association's *Model Plan of State and Local Taxation*,

³ Cf. the definition given by Professor S. E. Leland, in his comprehensive study, *The Classified Property Tax in the United States* (1928), p. 41.

where it is declared that "tangible property, by whomsoever owned, should be taxed by the jurisdiction in which it is located, because it there receives protection and other governmental benefits and services."⁴ Since it is not easy to distinguish among the several degrees of benefit rendered to the different classes of property in any tax district, a strict construction of this principle would lead to a uniform rate on all tangible property, that is, to no further effort at classification. Such, indeed, was the conclusion of the committee which revised the model plan in 1933, the reasons being that revenue was urgently needed, that more vigorous efforts were being made to assess tangible personal property, and that gratifying success had attended these efforts.

Nevertheless, the assessment of certain classes of personal property encounters administrative difficulties that are rendered more serious by the attempt to tax them at the rates ordinarily applicable to real estate. When such difficulties are experienced by competent assessors, the case becomes reasonably clear for a different method of treatment. The whole argument for classification rests fundamentally on the proposition that thereby can be secured more revenue, and a better distribution of the tax burden among all property owners, than can be expected by an uncompromising enforcement, or attempted enforcement, of a uniform method. Consequently, the best ground for segregating a particular class of property for taxation at a different effective rate than is levied upon other property, is that such a course will diminish evasion, promote a more complete and equitable assessment, and provide more revenue from this class in the long run than can be expected under the policy of uniform taxation.

The establishment of separate classes of property on such grounds as these must obviously proceed with caution. Definite and conclusive evidence of the bad and probably incurable assessment conditions under the rule of uniform taxation should be at hand, supported by the results of a fair trial at vigorous assessment, before segregation is made. If the position taken by the model plan be accepted, relative to the basic reason for taxing property, then concessions made to particular classes of property, through assessment at some fraction of full value or the levy of a lower tax rate, should not be viewed simply as a means of conferring a special privilege upon these classes, but as a means of arriving at more adequate taxation of them in the long run.

The foregoing cautions have been observed in some instances of classification, but this can hardly be said of all cases. Vessel property is in a sense migratory, and hence may properly be classified for differential taxation; a similar reason exists for the differential treatment of private car lines. The bushel tax on grain in elevators, found in Minnesota, is defensible since the grain could be stored elsewhere if the tax rates in the

⁴ *Proceedings of the National Tax Association*, 1933, p. 361.

Twin Cities were too high. Timber lands devoted to timber production differ sufficiently from other lands, so far as concerns the periodicity of the crop produced, to warrant special classification. Mines of the type in which the ore deposits cannot be mapped and appraised by test drilling present also a special case. These are examples of a defensible policy of classification.

On the other hand, a distinction in the basis of assessment between farm lands and city lots, as in Minnesota, can hardly be defended. The alleged reason for these discriminations is that they merely validated the existing assessment practices at the time the law was enacted, but this is neither adequate nor convincing. The Ohio classification scheme of 1931, whereunder the machinery, raw materials and finished products of manufacturers, and the machinery and livestock of farmers, are to be assessed at 50 per cent of full value, the goods and equipment of merchants at 70 per cent, and the property of public utilities at 100 per cent, must also be condemned.

The Ohio plan taxes intangibles (such as stocks, bonds, mortgages and annuities) at 5 per cent of the income yield, but at two mills on the dollar of full value if no income has been received during the taxable year. Ostensibly this device is intended to adjust the tax according to the relative capacity of income-producing and non-income-producing investments. In fact, there is but little actual differentiation, for the tax on \$1,000 worth of non-dividend stocks would be \$2.00, while that on a \$1,000 bond yielding 4 per cent interest would be \$2.00. Further, bank stocks and bank deposits are alike taxable at two mills on the dollar, while moneys and credits and all other intangibles are taxed at three mills. Such a scheme is over-elaborate, and hence unnecessarily confusing, both to the taxpayer and the administrator. A three-mill rate on all intangibles, such as is found in Minnesota and Maryland would have been far simpler, much less complicated in operation, and no doubt fully as productive as the existing plan, which strives vainly after careful distinctions.

ELIMINATION OF PROPERTY TAX LEGISLATION FROM CONSTITUTIONS

A second important problem is presented by the tendency to legislate concerning the property tax in state constitutions. The great misfortune of an earlier generation, so far as this tax was concerned, was the fact that in so many states the rule of general uniformity, that is, the general property tax, was written into state constitutions. There it remained in some cases long after it had been rendered obsolete and actually harmful by changing conditions, despite vigorous efforts to secure modification. The historical lesson has been forgotten or disregarded, for many states are now engaged, through the process of amending their constitutions at

general elections, in writing various provisions relative to the property tax into their respective constitutions. None of the recent amendments may lay legitimate claim to being a counsel of perfection, a claim that could with some reason have been made for the uniform rule when it began to be incorporated in state constitutions during the middle of the last century. The present proposals are being advocated frankly to benefit particular group interests, and all manner of questionable appeal and representation is being made in their support.⁵

This tendency is extremely unfortunate and should be checked. In fact, the best constitution is that which makes no reference to methods or forms of taxation, leaving these subjects wholly to the will and discretion of the legislature. The stock argument against such a policy is that legislatures cannot always be trusted (as if those who seek to legislate via the constitution could always be trusted), hence, some kind of constitutional prescription is needed. It is always invoked most vehemently when effort is being made to insert some provision of a purely statutory character into the organic law.

DEVELOPMENT OF AN ASSESSMENT AND EQUALIZATION TECHNIQUE

The problem of determining an acceptable value of property for tax purposes is naturally the central issue in the satisfactory operation of an ad valorem tax on property. As was indicated in the preceding chapter, American property tax laws have always been written on the assumption that an open and sufficiently active market existed for every different species of property, and that the assessors' chief task would be to become thoroughly familiar with actual selling or market values.

A reasonable construction of any property tax law leads to the interpretation that the legal rule of sale or market value is really intended as a guide in the establishment of relative assessments. In no tax district is all of the property sold in any given year, or in any reasonable number of years. The fact that one parcel is sold at a certain price constitutes presumptive, but not conclusive evidence that a similar, adjoining parcel could be sold for the same price. The requirement that each parcel of real estate shall be assessed at the price for which it would actually sell is, therefore, a pure fiction. If it has not been recently sold, no one can accurately determine the price that would be paid for it in a voluntary transaction.

This does not, however, invalidate property assessments, nor does it destroy the basis of an adequate technique of assessment. After all, the fundamental task of a good assessment is that of establishing reasonable and equitable relations among the several parcels or tracts of land in an

⁵ Cf. *Proceedings of the National Tax Association*, 1934, pp. 41 ff.

assessment district and throughout the state. Relative uniformity is, after all, the basic requirement of property valuation for tax purposes. No tax administrator could be found who would contend that all property had actually been assessed exactly at what the several parcels would bring if sold. All property in a state may be assessed at some fraction of its selling value, but no injustice is deemed to have been done thereby as long as the under-valuation is regarded as being fairly even. Nor would there be serious local or individual basis for complaint if every parcel were assessed at double its selling price, although such a policy might be objectionable on account of its effect on local expenditures and debt limits.

Substantially, therefore, the problem of assessment is one of determining fair relative values. Fairness in this instance consists in finding a satisfactory answer to the following question: If this piece of land is worth so much, as indicated by a recent sale, or other dependable criteria, and should be assessed for so much, what valuation should be placed on that piece, considering its location and economic usefulness in relation to the first piece? When all assessed values are smoothed out acceptably by a universal consideration and application of this logic, the level of assessment may be high or low with respect to actual selling prices, but the assessment is nevertheless equitable. The assessor must of course seek to establish his basic values on a plane that corresponds as nearly as possible with the level of actual market values, as indicated by sales, rentals and other pertinent factors, but it is far more important that he should determine reasonable relationships in his appraisal than that he should approximate exactly an actual sales price that could be realized in each case. In other words, the assessor proceeds from the known to the unknown, in that he starts with parcels of property the value of which has been registered by sales, rentals and other indicia, and projects a relative, comparable level of values for those parcels or tracts which have not been sold.

This principle of relative or comparable valuations is the more important because the property tax is one of the important ways by which the contributions of different individuals to the cost of government is determined. The proportion of the total cost of a city government, for example, which is to be met out of a property tax may be high or low. This is a matter of public policy on the state level as well as on the municipal level, and there is no abstract principle of justice or equity by which the matter can be infallibly settled. The most important practical problem is to establish a level of property taxes that the property owners will pay.

The sheer weight of these taxes may be a factor, but it is not always the principal one, in determining the attitude of property owners. The wide variations in property tax burden in different cities indicates that heavy taxes will be paid on property. To be sure, when this burden becomes such as to absorb the whole value of the property in a short time,

owners are inclined to cut their losses by refusing to pay. Their willingness to pay is influenced, however, by the degree of their acceptance of the assessments as being comparable, and as being, therefore, a reasonable and acceptable basis for the determination of the proportion of the property tax which each one pays.

It is from this point of view that modern assessment and equalization techniques should be constructed and operated. It is the only feasible viewpoint to take, and if the procedure is adequate, it will result in a reasonable distribution of the taxes levied on property.

A full account of current good assessment technique would be too long and too complicated for the present purpose. Some general features only will be outlined, in order to illustrate the method and the objectives. While excellent practices may be found in many places, their observance is still so far from general that their extension constitutes a serious problem in tax administration. The simplest case is that of rural land appraisals; urban lands involve some further technical complications; and the appraisal of great railroad and utility property aggregates is most difficult of all. The discussion will follow, in general, this order.

The appraisal of rural lands. The first essential in land assessment is a proper survey of the land, in order that the location and area of the several tracts may be accurately determined. The newer states have been fairly completely surveyed, except for some mountainous and desert sections, but some of the older states, which were settled before the rectangular survey system was inaugurated, lack the records for correct location and area determination in all cases. Under such circumstances the assessor cannot always describe a farm by reference to range and township lines. He must simply list it as the farm belonging to William Robinson or John Brown, and make a guess, or accept the owner's guess, as to the acreage. In an assessor's book in a rural Maine town the author found an assessment which was described simply as "Part of the Young farm." Under the law of some states an assessment is not valid if the property assessed is not correctly described. No tax sale would be valid anywhere if the property description is vague and indefinite.

Land classification. The second essential for good rural land assessment is an appropriate system of land classification. As used here the term *classification* must not be confused with its use earlier in the chapter. There it meant the creation of classes of property for differential taxation. Here it means the designation of land by classes, according to its character and its probable economic usefulness. In this sense, a scheme of land classification is a fundamental prerequisite to the determination of its relative value, and to the interpretation and application of sales as a guide to values.

The content of a method of land classification must be governed by the local characteristics within each state. A classification suitable to Ver-

mont would probably not be satisfactory for Iowa. The Wisconsin tax commission has prepared a comprehensive classification of lands, both urban and rural, which the assessors are required to follow in writing up their assessment records.⁶ The main headings are as follows:

Class *A*—Residential

Class *B*—Mercantile

Class *C*—Manufacturing

Class *D*—Agricultural

Under this head there are five sub-classes; three for lands that have been cultivated, according to quality, one for wild hay land and one for wild pasture land.

Class *E*—Marsh, cut-over and waste

Class *F*—Timber

The Wisconsin assessor's field book contains columns for each of these classes, and he is required to enter therein, for each farm, the number of acres of each type of land in the farm. As a further guide, he is expected to prepare, in a plat book, a topographical sketch of each holding, showing the location of streams and ponds, highways, declivities and other features, also the location and approximate area of the several classes of land; and, by appropriate markings or colorings, variations in soil characteristics. Some of the Wisconsin assessors have made extremely creditable amateur soil and topographical maps of their respective districts.

Eventually, there should be developed for every assessment district, careful and reliable maps of this sort. Since the principal aspects of soil and topography do not change, such work need be done but once. By laying out a program to be executed over a period of years, thorough mapping of tax districts could be done without great additional expense. On the basis of these maps, further data could be accumulated, along the lines of the European *cadastre*, which is a double-barreled survey. It includes the physical survey of "metes and bounds," and also a description of the economic characteristics and resources of the land.

Once the main task of map-making has been completed, the current map work will consist of noting any changes that may have been made, through drainage, clearing, and the like, whereby lands have been transferred from one class to another. The results of federal and state geological surveys, and the studies of soils made by state departments of agriculture, are very useful in preparing these maps. All cities have plat books and other maps, showing the size and location of urban land parcels, and in the copies of these records used by the assessor, the zones or classes according to use should be distinguished.

Supervision. A third essential of good assessment technique is high-grade supervision. This must be done by the state tax commission, but it

⁶ Wisconsin Tax Commission, *Assessors' Manual* (Madison, 1930), pp. 17-20. See also, Illinois Tax Commission, *A Manual for Assessors*, 1935.

cannot be intelligently done unless the commission is itself of high grade. Needless to say, such supervision will be as necessary and as helpful for the urban as for the rural assessors. There must be provided all of the proper field books and forms, a clear and simple assessors' manual, and a continuous and vital contact between the commission and the assessors. The Wisconsin scheme of district supervisors of property assessment, already described, appears to fulfil the purpose of effective contact between state and local officials better than it is being accomplished elsewhere, and for this reason it is commended for general adoption.

Sales data. A fourth essential, also equally valuable for urban and for rural assessments, is the collection and analysis of sales data. The volume of real estate transfers varies widely with general business conditions, and during depression years the scope of the free real estate market is materially narrowed owing to the increase of forced sales. Nevertheless, sales transactions should be accumulated and analyzed, with a view to providing such index as may thus be afforded to the drift of market values.

Much careful investigation is required before a transfer of real property can safely be used as an indication of what would be paid in a free and voluntary transaction.⁷ First of all, the actual consideration must be determined, through correspondence or interviews with the buyer and seller. The recorded or reported price may be very different. Next, it must be a cash transaction. Trades and deals involving in part an exchange of property must be rejected. All transactions between relatives must also be determined, for experience has shown that many of these are influenced by other than cool business motives. The purpose of the sale must also be considered. If a farmer is buying an adjoining quarter-section to round out his holdings, the price he would pay is not always a fair market criterion; nor is the price that a liquor dealer or an oil company would pay for a corner location in a city necessarily to be regarded as a proper indication of city realty values. All sales to non-residents, otherwise known as "sucker sales," also go out. Naturally, any evidence of a forced or liquidating sale would invalidate the transaction.

Some communities have been plunged into financial difficulties because their assessors and governing bodies failed to recognize and discount speculative land booms. Rising assessments in the boom areas are useful as a brake on the inflation tendency, but these communities too often proceeded to regard such values as permanent and to extend their budgets, both for current and for capital purposes correspondingly, only to find themselves confronted, later, by an appalling volume of tax delinquency after the land bubble had exploded. Sales that are open to any suspicion of speculative influence should be rejected, or strictly limited in application to the boom areas.

⁷ Cf. H. L. Lutz, *A Manual for the Use of Sales Data* (mimeographed), Princeton, N. J., 1938.

The investigation of sales preliminary to their acceptance as a guide to fair market values, must be done by or under the supervision of the tax commission, in order to provide uniformity of policy throughout the state. In part it is a task for field investigators, and the assessors or the supervisors of assessment may perform this field work. In part, also, it is a task for competent examiners in the central office. Data relative to the acceptable sales should go to the assessor of the district in which the property is located. His task is then to view the property and make his own independent appraisal of it. To an assessor trained to classify land and to think of it in terms of its soil and topographical characteristics, the sale of a farm becomes something more than a farm sale. He naturally seeks to discover the relation between the value of the good land and that of the poor land in the tract transferred, and his conclusions enable him to make a check on his valuations of similar lands throughout his district.

The appraisal of urban lands. The city assessor requires all of the equipment, training and guidance that have been suggested for rural assessors, and, in addition, various technical aids that are of less importance in making rural assessments. He is dealing with concentrated land values, expressed in values per front foot rather than in acres. His procedure must be more exact, and his tools must be calibrated to measure much larger sums.

Since the assessment process consists in arriving at appraisals which approximate market values as closely as possible, the assessment technique naturally conform to private valuation practices. The ordinary unit for valuing city lands is the front foot, which means a strip of land one foot wide and a certain number of feet back from the front line of the lot. The standard distance or depth of the unit, is usually 100 feet. The depth of the standard unit will depend somewhat upon the size of the typical city block, which will depend in turn on the scale on which the city is laid out.

The basic problem of city land valuation becomes, therefore, the establishment of proper unit values. When this is done, by methods to be discussed presently, the calculation of the value of all lots of standard depth becomes a clerical process. But all parcels of city real estate are not of the standard depth. A continual process of subdivision of holdings is going on, so that the lots at any one time may vary considerably both in size and shape. They are not always true rectangles, but may have sloping sides, or they can run to a point, or have other irregularities. These tendencies are often accentuated by the plan of the city streets. The application of the unit system of valuation requires, therefore, the development of certain supplementary rules and principles for dealing with the irregular and variable cases.

The first of these is the method of apportioning the value of the

standard land unit in case the actual depth of the lot is less or greater than the normal. For example, the value of the unit on a given street may be \$4,000. This means that a strip one foot wide and 100 feet deep is worth that sum, and a lot twenty-five feet wide by 100 feet deep is considered to be worth \$100,000. But how much is a lot worth which is twenty-five feet wide and only fifty feet deep? Or what is the value if the lot is 150 feet deep? These problems require the use of a depth rule or scale, according to which the value of the unit is distributed from front to back. It is doubtless true that the portion of the unit nearest the street front is most valuable, and the various scales in use have been constructed on this assumption.

Several of these rules are now used in different places.⁸ Two of the best known are the Lindsay-Bernard rule and the Somers rule. In the main these rules and most of the others used agree in assigning about 70 to 72 per cent of the total value of the unit to the first fifty feet, if the standard depth is 100 feet. For lots with depth greater than the normal, the progression in value is continued, but at a diminishing rate, since it is evident that the portion of a lot which lies more than 100 feet from the sidewalk will be relatively less valuable for most urban uses than that portion which is less than this distance.

Other features of an adequate assessment system for urban use that are involved in the application of the unit foot method of valuation are suitable methods of calculating corner influence, alley influence, and for dealing with lots of irregular shape and in unusual locations. As in the case of the depth rule there are various methods in use for dealing with these and similar special problems that may arise. If the system of rules is adequate and approved by the results of experience, the computation of lot values becomes a relatively simple and routine procedure after the unit values have been agreed upon.

The determination of the unit values is the part of the task of assessment upon which the accuracy and equity of all largely hinges. This determination must rest upon sales, rentals, character of the use, relative importance of the street for business or residence purposes, and so on. A well-organized assessor's office will keep a part of its staff at this task of checking up on the trend of unit values in every part of the city. This

⁸ Some of these rules are described by the Committee on Assessment of Real Estate, *Proceedings of the National Tax Association*, 1911, p. 350 ff. See also H. L. Lutz, "The Somers System of Realty Valuation," *Quarterly Journal of Economics*, Vol XXV, p. 172 (November, 1910). The subject of land appraisal was discussed at the Sixteenth Annual Conference of the National Tax Association; see *Proceedings*, pp. 45-113.

It is possible that some of the depth rules may minimize the value of extra-depth lots when the land is used in such way as to permit effective utilization of every part, as in the case of apartment houses. Allowance for such conditions will require the application of judgment on the part of the assessor.

must be a continuous process if its results are to be worth using at the time the assessment is actually made.

The method of determining unit values in Cleveland, Ohio, has been carried to a high pitch of perfection by an efficient assessment organization. The foundation of this method was laid in the reappraisal of 1910, which was conducted under the Somers System.⁹ The underlying assumption of this system, which is still employed in Cleveland, is that the determination of unit values should be made by public or community opinion, although the county auditor assumes final responsibility for the figures actually established.¹⁰ Tentative unit values are prepared by the office, acting in coöperation with committees representing owners and users of real estate as well as the professional dealers in this form of property. Maps showing these unit values are broadcast, and meetings of persons interested are held in different parts of the city, and of the adjoining suburbs. The information elicited through these public meetings is supplemented by that collected by special agents, and on the basis of all available data, the unit values are established for the entire metropolitan district. This procedure seems to be sound in theory, and it affords the great practical advantage of stopping most of the complaint and criticism of the results which might naturally arise against a purely official determination.

It is always necessary to provide for a review of the original assessments, however these may be made. Such review and possible redetermination of the assessment by an appeal board should be as simple and free from red tape as possible. Local boards of review, if properly organized and composed of an intelligent personnel, may be able to correct many grievances. Ultimately the results of the assessment may need to pass before the state tax commission, and a final appeal from the action of local assessing authorities should always be readily open to the taxpayer.

The appraisal of buildings. The problem of the proper assessment and taxation of buildings and other structures on the land is almost wholly one for the cities. The separate assessment of lands and improvements is now quite general, but the task of appraising farm dwellings, barns and other structures and improvements is simple beside that of valuing properly the bewildering array of structures in the modern city. The general principles of building appraisal are as applicable in the country as in the city, and when these principles are made part of a proper assessment system their use will become universal.

As in the case of lands, the first essential is a proper building classification. It is manifestly unsound to undertake the task of appraising the

⁹ H. L. Lutz, *loc. cit.*

¹⁰ Cf. unit values established in the 1931 assessment, published by the County Auditor.

many different kinds of buildings in a great city without some kind of classification of these structures according to their use, their character and quality of construction, and the degree to which they serve their intended use well. In the Cleveland reassessment of 1931 five different classes of structures were established with several sub-classes within each, and the descriptions of the type of building within the different sub-classes were generalized and standardized so as to permit of as wide application as possible. For the aid of the assessor, and the instruction of the public, photographic reproductions of illustrative buildings within each class were published. A similar technique is now found in all of the larger cities.

A second important problem is the determination of a proper series of value factors for the different classes of buildings. This is a complicated and perplexing task, and on account of the differences in building codes, materials and costs in different parts of the country no universal series of value factors can be established. The usual method is to measure the amount of ground floor space occupied by the building, and multiply this area in square feet by a factor which is assumed to represent the value of a typical building of this class. The multiplier can be graduated according to the number of stories in the building, but not as rapidly as the height rises, since the cost of construction and the value of the building do not mount in this ratio.

A third important consideration in the appraisal of buildings is depreciation. The valuation that is determined as outlined above is supposed to be on the basis of original or reproduction cost, and the scale of value factors is arranged on this assumption. But the assessment must take into account the actual present condition of the structure, and so depreciation is necessary. Under exceptional circumstances the building must be appreciated, but no general rules can be formulated to cover this contingency. On the other hand, there is ample experience in calculating the rate of depreciation of various types of building, and the best rule to follow here is the current business practice of a given community.

The appraisal of personal property. The possibility of assessing personal property satisfactorily is a subject on which there is some disagreement among both tax administrators and students of taxation. From the standpoint of accessibility, the task is more difficult than in the case of real estate, for personal property can be secreted or removed from the tax district. But from the standpoint of establishing reasonable values, the task is easier, since a fairly ready market still exists for most forms of personal property, a situation no longer true of real property.

Further, all business concerns of any size keep books of account, in which their various types of personal property, whether inventories of goods on hand, supplies of materials, or equipment, are valued and depreciated or appreciated according to current market changes. The

assessor can use this information as a guide to fixing his assessments on such property.

Some forms of personal property may have no market value other than a scrap value, or a sentimental value to the owner. Specialized types of machinery, used personal effects and house furnishings are illustrative. Good judgment and a sense of fairness in dealing with individuals are essential in assessing such property.

The success of personal property assessment depends in large measure upon the attitude of tax officials and the public toward this feature of the property tax. On this point the following comments from the *Illinois Assessors' Manual for 1935* are apropos:¹¹

A good personal property assessment depends upon securing the willing and honest co-operation of the taxpayer. The situation is quite different here than it is in the assessment of real estate. It is visible, cannot be concealed and is not removable; but personal property, unless the confidence and co-operation of the taxpayer are secured, will be made the object of these and other subterfuges calculated to defeat the making of a good assessment. Many items of personal property are especially apt to be omitted, unless the assessor or his deputy visits the residence of every taxpayer and makes a personal inspection and appraisal, as he is required by law to do. Even if a personal inspection is made, it is difficult to secure a complete listing of the property of any one taxpayer, if the various items are scattered at different addresses. Every effort should be made on the part of the assessor to instill confidence in the taxpayer as to the impartiality and integrity of the assessing officials. No assessor should take advantage of the ignorance of the taxpayer with respect to the law, assessors should regard themselves not only as agents of the government, but also as agents of the people themselves....

It requires tact and courage on the part of an assessor to assess fairly and completely the property of his district according to the laws of the State. In order to obtain a good assessment the taxpayer must be assured that he will not be subject to arbitrary and unreasonable discrimination, and that he will not be penalized for his honesty and candidness.

The forms of personal property are so varied that further discussion of the practical problems of assessment must be passed over. The properly staffed assessor's office may well have one or more specialists in various important forms of personal property that exist in the district. As suggested above, it is possible that some reasonable degree of classification and differential taxation of such property may promote that candid coöperation between taxpayers and assessors which the Illinois Tax Commission has stressed in the paragraphs quoted above.

¹¹ Illinois Tax Commission, *Assessors' Manual for 1935*, p. 103. This manual contains some excellent suggestions and guides for the effective and equitable assessment of personal property. See pp. 103-117. Also, William H. Blodgett, "Present Practices in the ad valorem Taxation of Tangible Property," *Proceedings of the National Tax Association*, 1929, pp. 456-468. This study revealed that administrative defects in the tax law were more generally responsible for defective personal property assessment than the character of the property. Cf. *ibid.*, pp. 462, 463.

The appraisal of railroad and utility property. The duty of assessing such properties was long ago removed from local to state jurisdiction. Since many of these properties cross state lines, the change has not solved the problem of assessment, although it provided an administrative area more nearly commensurate with the task. Railroad assessment will be outlined as the most important illustration of the general problem.

It must be emphasized that despite the quality of the judgment of the assessing officials, the whole procedure of railroad valuation is in the realm of fiction and "make-believe." The simplest and most rational solution of the problem of railroad taxation is to abandon altogether the fiction of determining such values and substitute instead the taxation of gross receipts. As it turns out, the so-called valuation process involves so many unknowns and so much weird rationalization, that its principal result is to provide a means whereby the railroad tax burden is adjusted up or down in accordance with the public attitude toward the subject.¹²

As long as constitutions and statutes require the determination of an assessed value of railroad property, the duly responsible officials must engage in the shadow-boxing necessary to establish a tax base. Because of the widespread use of the capital value base, the subject is discussed here with a view to contributing to the task of making fiction appear as much like reality as possible.

The assessment of a railroad property for taxation involves three important and difficult steps. These are (1) the determination of the fair value of the property for taxation, (2) the allocation to the particular state of such part of this value as may justly be taxed by that state, and (3) the determination of the rate or rates of tax to be imposed. It will be impossible to do more here than to outline the character of these operations and give some slight indication of the methods of dealing with them.

Valuation. The starting point is the determination of the fair taxable value. In legal theory, railroad property, being a part of the whole mass of taxable property, is to be valued by the same standards as are applied to other property. Tax laws ordinarily state that all property shall be assessed at its "fair market value," or its "true value in money," or its "full cash value." These and similar expressions hark back to the beginnings of property taxation, when property units were small and were of such character that there was more or less regular buying and selling. They assume that a market exists in which prices are being established, and that the assessor may find in these market values a reasonable guide to taxable values.

Evidently these assumptions are not sound today, for large masses of property. There is no market in which steel plants, office buildings or

¹² Cf. H. L. Lutz, *The Taxation of Railroads in New Jersey* (1940), especially Ch. III. The New Jersey experience is a conspicuous case of "soaking" the railroads under a peculiar local construction of the valuation principle.

railroads are bought and sold, and the naive way in which the tax law assumes that the assessor can rely on an actual market as a guide illustrates the unfortunate lag between legal concepts and actual conditions, a situation by no means confined to the field of taxation.

Some attempt has been made to correct this difficulty by permitting the assumption of a constructive market. Value is often defined as the price that would be paid by a buyer who is willing but not obliged to buy, to a seller who is willing but not forced to sell. This transfers the process of valuation from the field of facts to the realm of hypothesis, with the result that the judgment of the assessor becomes the most important factor in the process. If the members of the assessing board are fair-minded and intelligent, and have good judgment, a reasonable assessment can be made by the use of such tangible evidence as will illuminate the problem. If they lack these essential qualifications, unfair results may ensue.

The unit rule of assessment. It is now generally recognized that the portion of the property of an interstate railroad which lies within a given state cannot be properly valued apart from the whole property. State lines have no significance in this connection, and the valuation process must first apply to the entire property. It goes without saying that only the operating property is to be included, that is, the property actually used in the transportation process. This valuation of the entire property is called the "unit rule" of assessment.

The two most important guides to the unit value of a great interstate railroad property are (1) the investment in the property and (2) the net income from transportation services. Since these two factors are incommensurable, it is necessary to capitalize the net income at some reasonable rate of return, thus giving a capital value, on the basis of income, which can be compared with the investment value.

Property investment. The determination of the investment value of the property is not easy. Few railroad companies have records adequate to show historical cost, that is, total amount spent from the beginning. Their balance sheets show a certain book or investment value, and their engineers frequently have data on the basis of which to compute the reproduction cost, that is, the cost of building such a property in its present location at prevailing prices of material and labor. Schedules of depreciation are applied to establish the cost of reproduction in present condition, as distinguished from the cost of reproducing a brand new property. The Interstate Commerce Commission was engaged for a number of years in a valuation of the physical property of the railroads, for rate rather than tax purposes. Much criticism has been offered against these valuations, mainly on the ground that they are too low. They represent, however, a fairly complete inventory as of a given date, and perhaps a fairly accurate physical appraisal as of that date. Corrections for better-

ments and additions since, and for changes in price level are necessary to bring them up to date for either tax or rate purposes.

Stock and bond value. Another method which is sometimes employed is the so-called "stock and bond" method. This consists in computing, from stock market quotations, the value of each class of securities outstanding. The sum of these values, it is believed, gives the value of the property. This method has been widely approved by the courts. The argument in favor of it is that the securities represent the property, and the price that investors will pay for these securities, in a market where they are bought and sold every day, is said to be the best indication of the value of the property.

This argument in favor of the stock and bond valuation is not convincing, however, in view of the objections that may be urged against it. The stock market looks chiefly at the earnings, past, present and prospective. The assessing board must also do this, and thus the stock market uses a guide which is likewise open to the assessor. The best that can be said of the stock and bond method is that it may be useful as a corroborative check, since it reflects the judgment of others who are particularly expert on the question of trends.

But there are many factors, some connected with the business, and some external to it, which impair the reliability of stock and bond computations. Within the business, there is the matter of capital structure. Some companies are top-heavy with bonds, and there may be many classes of bonds. The heavier the load of fixed charges, the greater the risk to the stockholder through fluctuations of earnings. A company with no security but common stock outstanding might have to vary the dividend rate with the earnings but the stockholders would have a greater chance at some return than they would have if 70 to 80 per cent of the capital structure consisted of bonds.

The company policy of disposing of earnings also affects market quotations. While the accumulation of surplus and reserves out of earnings should mean eventually larger dividends, this does not necessarily follow, and it may be a long time coming. The wise investor may look far ahead, but the market is seldom controlled by wise investors. If the current dividend rate is low, the price of the stock may not accurately reflect earning power.

External to the business are all of those factors that determine the wild variations of stock market prices, such as the call money rate, the general credit situation, the volume of broker's loans, the international gold movement, the federal reserve policy, and the general state of affairs, national and international. None of these matters represents a careful judgment as to the true value of a given security, especially in an era of extensive speculation. The prolonged bull market of the twenties attracted the speculative public on such a scale that the ordinary rules of cautious

investment were hardly applicable. Under these conditions stock market quotations, by and large, do not represent careful investment opinion.

Finally, the assumption that the price of a block of shares, times the total number of shares outstanding, gives the true value of the entire stock issue, is invalid. The market buys and sells the available floating supply, churning it over and over. The day by day quotations are absolutely no guide to what would be paid for 51 per cent of the stock, or even for a sufficiently substantial minority interest to give the buyer an influential part in the management. The famous battle between the Hill and the Morgan interests for control of the Burlington in 1901 illustrates what may happen when someone sets out to buy a railroad in the stock market.

In the use of the stock and bond method a serious complication is presented by the non-operative property and the investment holdings which a given railroad company may own, whether in other railroads or in miscellaneous industries. The investor is primarily interested in the total net income and he does not ordinarily attempt to determine what part of the market price of his stock is the result of the company's transportation operations and what part is the result of other income. While the earnings per share from these respective sources may be reported, their relative influence on the price is not determinable. The non-operative property may have only a future or speculative value, but it must be allowed for to some extent in the value of the securities.

The important question is, to what extent? How shall these properties and other investments owned by a railroad company, but not used for transportation purposes, be valued? The stock and bond method affords no answer. Yet this practical problem must be faced by every assessment board that deals with the large railroad systems, for all of these systems own non-operative property. The assessing board is inevitably forced to resort to physical appraisal in some cases, and to the exercise of its best judgment in other cases, in valuing this property. The extreme advocates of the stock and bond method base their case on the superiority of the general market judgment as to values over the judgment of the assessing board, but it appears that the market and the assessor are not dealing with the same entity in any instance in which a considerable amount of non-operative property is concerned. Since the assessing body must fall back on its judgment or on other methods of appraisal in valuing this extraneous property, the stock and bond method loses much of its virtue. If these other methods of appraisal are useful in valuing the non-operative property, they may possess some merit for the main task.

In view of the dependence of the stock market on earnings, there seems to be no additional light on the problem from this method, although the comfort that some may derive from such a check may justify the elaborate calculations involved. In any case the assessing board obtains,

from its various estimates of capital value based on costs and on earnings, a series of limits within which the fair value of the property may be presumed to lie. Since a certain definite amount must be set down as the assessed value, it becomes necessary to exercise judgment in establishing this assessment. Experience and long familiarity with the trends in the general prosperity of the section served by a given railroad, as well as in the affairs of this road itself, are essential to the exercise of good judgment here, and these conditions constitute a strong argument for a long, stable tenure of office for the men who are charged with this responsibility.

Apportionment of assessment to the state. The second important problem of railroad assessment is allocation of the state's share of the unit value of the property once that is established. The best guide here is the actual location of the physical property, and for this purpose the Interstate Commerce Commission data will be extremely useful, whatever the shortcomings of this material may be as a guide to aggregate value. The essential thing here is a ratio—if the Interstate Commerce Commission's valuation showed, for example, that 17 per cent of the physical property was situated in a given state, then this percentage of whatever unit value the assessing board found for the property as a whole could fairly be assigned to that state. The rolling stock has no definite location, and the only practical method of allocation for this part of the property seems to be the relative mileage traveled by cars and locomotives within the state as compared with the system as a whole.

Equalization of assessment. The third step in the process is the determination of the rate or rates of taxation. After the state's share of the total value is assigned, it is necessary to "equalize" this assessment with that of other property. That is, if property in general is found to be assessed at, say, 75 per cent of full value, then the railroad assessment should be correspondingly reduced. The tax rates to be applied may be those levied on other property in the taxing districts through which the railroad passes, in which case the state board must make a further distribution of the property values to these districts. Or it may be the average rate on all other property over the state, as in Wisconsin. Whatever the disposition of the tax, it is decidedly more convenient for the corporation to be able to pay all of its taxes in any state in one sum, instead of in small amounts to hundreds of small units scattered over the state.

The practice of distributing the valuation to the small local districts in which the railroad property is located is unwise. It means that these particular districts enjoy the major benefit from the railroad taxes, and promotes local "gerrymandering."¹³ The Massachusetts plan of distribut-

¹³ An excellent example of manipulated school districts to take advantage of forest taxation is given in *Forest Taxation in the United States*, by F. R. Fairchild (1935), p. 147. It is a map of Tillamook County, Oregon.

ing the bulk of the railroad tax locally in the proportion that the cities and towns contribute to the state tax diffuses the benefits of this tax among all local taxpayers, instead of concentrating them into the particular districts in which the railroad property happens to be located. The California Tax Commission of 1929 proposed a state assessment of public utility property and a distribution of this value to the districts for taxation at local rates. This plan is open to the objections here raised, and appears to be less satisfactory than one that would permit all local property owners to share in the benefits.

THE ATTAINMENT OF MORE EFFECTIVE CENTRAL ADMINISTRATIVE CONTROL

The growth of central supervision of assessments under the state tax commissions was a notable advance in property tax administration. But the enduring results have not in all cases been satisfactory, and thus another problem is presented, namely, that of realizing all that may reasonably be expected from the agencies and the technique of central supervision.

One reason for the slump in the vigor and effectiveness of state tax commissions has been the political undermining of these bodies. It requires more courage than governors ordinarily possess to appoint the best available men to the tax commissions, regardless of party, and it requires a different standard of public stewardship than some appointees possess to regard the position of tax commissioner as wholly outside the field of party politics. No argument should be required, however, to show that tax administration cannot be honestly and equitably conducted on a partisan basis, nor to show that partisanship in this field becomes a prolific source of evasions, frauds, delinquencies and similar evils. The tax administrator, like the judge, should be above party or sectional strife.

A second reason for the failure of central supervision to be as effective as it should, is the physical remoteness of the supervisory agency for the local officials. This is not only a matter of distance, as in the states of larger area: it is due also to the greater number of assessors in the states which have not reorganized their local tax districts. More intimate contact may be provided either by creating fewer, large districts, thereby reducing the number of assessors, or by creating assessment supervision districts.

A third influence, operative in some states, has been the inferior status assigned to the central tax organization, as indicated by meager appropriations and inadequate authority. Legislatures and budgeting authorities alike have been singularly blind to the wasteful policy that they have pursued in establishing a central agency, presumably charged with the responsibility of supervising the operation of complicated tax laws and the collection of public revenues, and in hamstringing it by failing to provide

funds for an adequate and competent staff of employees. Further, the inferior status of the tax department has been emphasized by leaving the administration of various taxes scattered about the state house as ex officio duties of different state officials who are primarily concerned with other aspects of state government.¹⁴ While this diffusion of administrative responsibility does not interfere directly with the operation of the property tax, it is an indirect influence in that direction, since the supervisory authority and morale of the tax commission are naturally affected by the limitation of its powers, by its inferior status, and even more by the restriction of its funds.

Finally, there is everywhere an inadequate conception of the importance and value of continuous study of the operation of the tax system. Competent research is essential to equitable administration. The tax commission should be continuously engaged in the intensive study of tax conditions and tax problems. Only in this way can irregularities and inequalities be discovered and corrected. The degree of neglect for this fundamental condition of good administration is indicated by the number of "surveys" of tax systems made by special commissions and similar agencies. Few if any of these would have been required if the several state tax departments had had a proper standard of their tax research responsibility, and decent financial provision for making the necessary studies. In no field is such study more urgently needed than in that of the property tax.

A RATIONAL EXEMPTION POLICY

The states have never sought to tax absolutely all property of every description situated within their boundaries. Property belonging to the United States has always been immune, for constitutional reasons, and even in the period of the most widespread use of the general property tax, a certain list of properties, including public buildings and grounds, property devoted to religious, educational and philanthropic purposes, was exempted. A problem is presented by the steady expansion of the types of exemption and by the interjection of confused and opposed viewpoints relative to a proper policy of property exemption.

The exact volume of the property exemptions in the United States cannot be stated. Most of the states do not require the assessors to value and report the exempt properties of their respective districts, and in the few cases in which this is done, there can be no assurance of the accuracy of these reports, either with respect to completeness or to valuation, since the data compiled have no direct revenue significance. Without specific figures, however, enough is known relative to this aspect of the tax ex-

¹⁴ Cf. H. L. Lutz, *The Georgia System of Revenue; The Tax System of Maine*; also Illinois Tax Commission, *Report*, 1933, Ch. IX.

emption menace to cause many to realize that the spread of such practices must be checked.¹⁵

Property exemptions fall into the following principal groups.

I. **Public property.** *A. Property of the United States.* Such property cannot be taxed locally without the consent of the federal government, and this is extremely unlikely to be given. Federal property is widely scattered. Post offices and other federal buildings are found in the cities, large and small; national parks, reservations and monuments have been created in many states; and in certain western states, substantial proportions of the respective areas are still in the public domain. These public land states have urged repeatedly that they be given the privilege of taxing federally owned lands, but this could hardly be done consistently without permitting the eastern states to tax federal properties located within their borders. The net effect of such a move would be heavier federal taxation to provide the funds required to pay local taxes on federal property. Local taxpayers as a whole could hardly expect tax relief from such a plan.¹⁶ Occasionally a small municipality contains an excessive proportion of federally owned property, but the obvious solution in such a case, which is to reorganize the local boundaries so as to exclude the federal property and leave squarely upon the federal government the responsibility of financing the local services required on and for its own property, has apparently never been considered.¹⁷

B. State and locally owned property. The exemption of such property is logical, since there would be no advantage in taxing the citizens of a state or city in order to pay a tax on state or city-owned property. Since state-owned property is always situated in a municipality, there has been some agitation, always in these particular local units, in favor of having the state pay taxes on its property to the city in which it is located. This practice is nowhere followed.

Occasionally a city will own property in another municipal unit. An example frequently encountered is the dam, reservoir or watershed, or all of these, required and built for water supply purposes. In such cases, the demand of the unit in which such property is located, for the privilege

¹⁵ More complete details regarding exempt property are provided by Connecticut than by any other state. According to the reported data, for which complete accuracy is disclaimed, taxable property increased 9.6 per cent from 1929 to 1941, while exempt property increased 368 per cent. The percentage of private property in the exempt list to total exemptions declined from 49.5 per cent in 1929 to 46.9 per cent in 1941. *Quadrennial Statement by The Tax Commissioner of Real Estate Exempted from Taxation*, 1942, pp. 5, 6.

¹⁶ Cf. "Report of a Committee on Federally Owned Lands," *Proceedings of the National Tax Association*, 1927, pp. 215-241.

¹⁷ E. g., Raritan Township, Middlesex County, New Jersey, had, in 1931, a taxable valuation of \$9,539,344, and an exempt valuation of \$51,555,000; Gloucester Township, Camden County, New Jersey, had, in this year, a taxable valuation of \$4,905,974, and an exempt valuation of \$2,535,000. In both cases the exemption consisted largely of federal property.

of taxing it, is justifiable. On the other hand, the New York policy of requiring the state to pay taxes on lands taken into the state forest reserve to the counties in which these lands are situated is indefensible. It prolongs the existence of counties which should be reorganized so as to exclude the state lands, and imposes a tax burden on all of the people as a concession to local prejudices.¹⁸

The purpose and advantage of exempting public property are in general clear enough, since any taxation policy would mean simply a transfer from one pocket to another, although certain communities would benefit from the process. With respect to privately owned property, however, the case is entirely different, since the tax exemption is a definite saving to particular persons or groups, which must be made up by heavier taxes on others. The only clear basis on which to grant such exemptions is that of a public service to which the property in question is devoted. Viewed in this light, such private property becomes analogous to public property, in that it is devoted to the performance of services which would otherwise fall upon government. But exemption practices go far beyond the limits of such a test, as the following classification of private property exemptions shows.

II. Privately owned property exemptions. *A. Property devoted to educational and philanthropic purposes.* A reasonably clear case for exemption exists when private property is devoted, without profit or benefit to individual owners, to the services of education and philanthropy in its various manifestations. These are now recognized public services, and the setting aside of privately owned wealth, by the creation of endowments or otherwise, for their support in effect relieves the general public of a portion of the tax load that would otherwise be necessary. The taxation of such wealth would discourage gifts to colleges, hospitals, social settlements and the like, and eventually lead to heavier general taxation to provide the services forced into public budgets by cutting into the funds of private educational and welfare institutions.

It has been contended that a privately owned school or hospital operated for profit actually relieves the state as much as if it were not so operated, and hence that it is also deserving of tax exemption. But this argument overlooks the essential point that when wealth has been surrendered to a board of trustees, for the use of a university or a hospital, it has passed from the ordinary category of private ownership. The trustees are not free to abandon the college enterprise, for example, and use the equipment and endowment funds for hotel or resort purposes. The owner of a private school is free to do this if a greater prospect of

¹⁸ Cf. Tax Commissioner of Connecticut, *Report*, 1934, Table 3, "State Grant in Lieu of Taxes on Certain State-Owned Property, Paid to 102 Towns in July, 1934." The total distributed was \$25,415. Only seven towns received sums in excess of \$1,000, while forty-one towns received less than \$100 each. The wastefulness of such a policy is evident.

profit appears. There is an element of social advantage in any use of wealth, and if the process of educating or of performing operations for profit is a valid basis for tax exemption, then the grocer and the dairyman also have an equally valid claim.

The cloak of philanthropy is responsible, however, for some serious and extensive abuses of the tax exemption privilege. All sorts of organizations have secured exemption of real estate and other property on the ground of their philanthropic activities. These organizations are usually a mixture of private club and welfare activity, with highly variable proportions between the two aspects. The privileges of expensive buildings are limited to members, and the welfare services may also be limited to members, or the widows or children of members. Crippled children or other special groups are cared for in some cases. However small the proportion of the welfare service in relation to the club activities, it is all too common to find that complete tax exemption is accorded.

A reasonable solution for all such cases would appear to be, first, the valuation of all property on the same basis as other property; and second, an exemption of such proportion of this valuation as the expenditures from membership dues and all other receipts for welfare purposes bears to the total gross receipts. Thus the welfare element would be accorded tax exemption, as would be proper, and the private club element would be taxed, as it should be.

B. Property devoted to religious purposes. Since there has never been an established church in this country, the provision of facilities for public worship can hardly be regarded as an essential public function. Nevertheless, the exemption of church property has been allowed for so long that it is doubtful if any change of policy in this regard could be introduced. But all such exemptions should be construed strictly. The exemption should be restricted to the buildings and grounds devoted to the purposes of public worship. Parsonages, sites owned for future church building purposes, and other property owned but not actually used for religious worship purposes, should be taxed.

C. Cemetery property. When land devoted to burial purposes is owned by a mutual, non-profit type of association, tax exemption is entirely appropriate. But cemeteries and their appurtenances, such as chapels and crematories, owned and operated for profit, should be no more entitled to tax exemption than the building and equipment of the mortician.

D. The ordinary property of individuals and corporations. Under this heading comes a considerable list of exemptions of ordinary property. The list is too long to be detailed, but most of the items therein lack adequate defense. For example, it has always been customary, under the property tax, to allow each taxpayer a deduction of a certain minimum, usually \$100 or \$500, from his aggregate property assessment. Since this

deduction is allowed on each return of property, its principal effect is to increase the tax rate on the taxable property. It has long been customary, also, to allow a specific property exemption to veterans and to certain disabled persons, notably the blind. Favors of this sort must be defended, if at all, on sentimental grounds.

Recently a movement for a so-called "homestead exemption" has been spreading rapidly. It means outright exemption of all small residence properties, when occupied by the respective owners, and in some cases there is taxation of only a portion of a certain bracket of value above the exempt minimum. The figure commonly chosen is \$2,500 or \$3,000, with a possible fractional assessment on the value up to some higher amount.

This measure is frankly advocated by realty boards and other groups as a device to stimulate home ownership. Its advocates assume the social desirability of subsidizing small home owners by relieving them of all contribution toward the cost of the local government benefits and services which is ordinarily met from the property tax. They apparently assume, further, that the psychology of such a group will not be altered by the exemption, and that the beneficiaries will, as voters, scrutinize expenditure and bond issue proposals as carefully as if they knew their own taxes were to be affected thereby.

This proposal is illogical, unsound and undemocratic. It is a serious blow at the productivity of the property tax, and it will imperil the maintenance of essential governmental services, such as education, protection and health, in which the small home owners themselves are vitally interested. The proposal draws support from its appeal to class and group prejudices, which has become a characteristic feature of the technique of taxation changes.

Further, it is another instance of the refusal to seek moderation in taxation by effective expenditure control, for the heavy cost of government is thereby rolled over upon the larger properties while all incentive to curb expenditures is removed from a substantial group of voters. Moreover, it makes the tax bill the scape goat for the other obstacles to small home ownership, such as the inordinate costs of building, the heavy expenses of land subdivision, sales promotion and the like. The property tax, though heavy, is only one, and hardly the most serious obstacle to small home ownership.

III. The exemption of personal property. One other type of property exemption must be mentioned briefly. This is the exemption of some, or even all classes of personal property either on the ground that the administrative difficulties of assessment are too great, or that other taxes are being developed as substitutes.

The assessment problem is not easy, in the case of some kinds of personal property. Intangibles proved to be impossible of adequate assessment, while subjected to the high rates imposed on real estate. Segrega-

tion and taxation at a lower rate led to marked improvement in the assessment of intangibles, and more vigorous assessment measures would no doubt bring even better results. Household goods and personal effects can be reasonably well assessed, but both assessors and taxpayers have rebelled against resort to the house to house inquisition involved, and exemption of this type of personal property is therefore fairly common. With respect to personal property used in business, there is no good reason why a competent assessment cannot be made, provided the tax commission, the assessors and the people want it to be made.

Nor is there any strong reason why tangible personal property used in business should not be taxed by a state which intends seriously to retain and use a system of property taxes. Such wealth is property, it has a definite location and situs, and it is the beneficiary of governmental services. The courts, the police and the fire departments, give protection to merchandise quite as much as to buildings. The whole governmental and social scheme is as helpful and as beneficial to the owner of tangible personal property as to the owner of land. Consequently, if there is to be, as part of a general plan of taxation, a tax on property on the ground of governmental benefits, it may well be applied to tangible personal property. This does not militate against segregation of classes and the imposition of different effective rates on the several classes.

Owing to the wide differences in the vigor displayed in various states in assessing personal property, the relative importance of this whole class in the total of taxable property varies widely. Consequently, officials and taxpayers in some states have advocated complete exemption of this class, pointing to the steadily declining absolute and relative amounts assessed. New York has reached this stage, and a special investigating commission in Connecticut advised extensive exemptions of personal property, in that state on the ground that the revenue loss would be negligible and therefore easily made up by other taxes of a substitute nature.

The situation in some other states, where more vigorous assessment and a more general acceptance of personal property taxation have prevailed, is quite different. This is shown by the following comparisons:

<i>State</i>	<i>Year</i>	<i>Ratio of Tangible Personal Property to Real Estate Excluding Public Utility Assessments</i>
Illinois	1940	29.0
Utah	1938	24.3
New Jersey	1943	22.6

Under circumstances such as are revealed here, the exemption of personal property becomes a serious matter from the standpoint of the

revenue involved. It could be made up by heavier taxation of real property, by the resort to other methods of taxation than the property tax. Of the states mentioned above, Illinois and Utah already have a sales tax, yet for local support there is substantial reliance upon personal property taxation. In New Jersey there is relatively heavy taxation of railroad property, particularly those classes of such property which are subject to local tax rates. In Ohio the taxation of property has declined in relative importance under the operation of constitutional provisions limiting the rate of tax levy. Paralleling the restrictive effect of these limits (15 mills in 1929, and 10 mills after 1933), there has been a steady increase in the proportion of total taxes provided by excises of various sorts. In 1931, the first year in which the tax rate limitation was effective, property taxes constituted 83.48 per cent, and excises 16.52 per cent, of all tax revenues. In 1940, the proportions were 61.71 per cent and 38.29 per cent, respectively. Through this period personal property taxes ranged from 8.76 per cent to 10.64 per cent of the grand total.¹⁹

One difficulty with taxes levied in substitution for the personal property tax is that they are seldom, if ever imposed simply in lieu of the tax on the property removed from the tax rolls. They are frequently broader in scope than this, and therefore fall on some who do not gain by the exemption. The Ohio situation is not a complete substitution of excises for the property tax, but an arrangement whereby the tax load, once borne very largely by property, has been transferred in substantial part to other tax bases. It is, in effect, a shift from owners to non-owners of property, although property owners pay a portion of the excise taxes. The shift has been more effective in broadening the state and local tax base than it has in controlling total expenditures. In fact, the Ohio Department of Taxation has pointed out that the primary objective was a transfer of tax burden rather than economy.²⁰

The personal income tax is often urged as a substitute method of taxing intangible personal property. The Ohio income tax, which is restricted to one on the income from intangibles, is the only one which fits this particular purpose. In other states, the income tax has been applied to income from all sources. The land owner is taxed on his income at the same rates, according to the amount, as is the owner of intangible property, although he is also taxed on the land as property. There will still be lack of parity in the property tax, if any sort of classification be introduced, but there will be, at least, recognition and application of the principle of universal taxation of property at some rate if there are no exemptions of whole classes of property.

Another example of substitution is the business franchise tax in New York. Manufacturing and mercantile concerns which pay this tax are not

¹⁹ State of Ohio, Department of Taxation, *Annual Report for 1941*, Table VI.

²⁰ *Ibid.*, p. xvii.

required to pay a tax on their personal property. Since the rate of the New York business franchise tax is only $4\frac{1}{2}$ per cent of the net income from the business done within the state, the result is that these concerns pay less tax, on the whole, than they would if their personal property were properly assessed, as it could be. The final effect of this substitution is, therefore, heavier taxes on real property in New York State.

LIMITATIONS OF PROPERTY TAX RATES

The spread of property tax rate limitation, in some cases by constitutional amendment and in others by statute, is symptomatic of another problem in the taxation of property, namely, the control of public expenditures and the proper and equitable distribution of tax burdens. The practice is not new, for there are many instances of such limitation, usually imposed by statute, on the rates to be imposed by cities and other units, either for specific purposes or for all purposes. The earlier use of tax rate limitation was, however, marked by a sufficient degree of flexibility and liberality to prevent serious interference with local services. Historically, local units have been largely dependent upon the property tax for their revenue, and Table XXXVIII on page 365, reveals the extent to which this condition still prevails. The recent demand for tax rate limitation has been characterized by a ruthless disregard for all of the factors that have contributed to the increase of property taxes, and for all of the fundamental changes that are essential if these taxes are to be permanently reduced.

The proponents of the movement have advocated it for two major reasons: first, they have contended that only through limitation of property tax rates so drastic as to threaten local services could sufficient pressure be brought against legislatures to secure enactment of other taxes deemed necessary or desirable for a proper broadening of the tax base; and second, they have held that property, as such, should be levied upon for only a certain proportion, usually put at one-half, of all taxes to be imposed. In this connection they point out that other taxes are levied at fixed rates, as in the case of taxes on incomes, inheritances, gasoline, and so on, and a similar fixity of tax rate is demanded in the case of the property tax.²¹

The tax rate limitation plan is an impulsive and badly designed method of correcting a situation which is, for the property taxpayer, admittedly serious. Property tax rates have risen steadily everywhere, and in many places they have attained an excessive and unwarranted level. The discussion of the factors contributing to high governmental costs in Chapter VI reveals the complexity of the problem of affording general tax relief.

²¹ Cf. Public Administration Service, *Property Tax Limitation Laws*, edited by Glenn Leet and Robert M. Paige (1934).

Property tax rate limitation neither proposes nor accomplishes anything constructive with respect to these fundamental conditions. It may force reluctant legislatures to enact other tax laws, and thus to develop other revenue sources; but this course can never lead to a lowering of governmental costs nor to a reduction of the aggregate taxes to be paid. On the other hand, it tends to divert popular attention from the real issues involved, while it thereby renders necessary continuance of a wasteful state subsidy policy in support of the local units that have been crippled financially by the limitation. Property owners are likewise consumers, and if the reduction of property taxes is made up by a sales tax, the small property owner, in particular, is not likely to enjoy much total tax relief. Persons with large incomes and large properties may benefit from the substitution of sales and other indirect taxes for a portion of their property tax.

It is essential to accurate budgeting that there be some elements of flexibility in determining revenues. If all tax rates are rigidly established, the whole policy of financial planning becomes inflexible, and under such circumstances deficits are much more likely. The budget-equalizing taxes must be substantial and reasonably dependable. In the case of local budgets, the property tax is the only one that could possibly serve adequately as an equalizer, and in order to serve this purpose, there must be freedom to vary the rate. Inability to do this will lead to borrowing for current operations, as was demonstrated in Ohio under the tax limitation measure of 1910.²²

Finally, property tax rate limitation, which must necessarily be uniform in application throughout the state, ignores the wide differences among districts with respect to taxable wealth, governmental needs, population, and so on. A limitation entirely adequate for rural units would be a severe restriction for some urban communities, and conversely, if the limit were high enough to enable the cities to operate, it would be quite ineffective as a curb on the tax levies of the rural districts. The scheme furthermore ignores the differences in the basis of assessed valuations, in states that have not established adequate reviewing and equalizing agencies. To be sure, assessments can be raised, if the former level does not provide sufficient revenue under the limitation, and this loophole has in some cases been utilized.²³

²² Cf. remarks of Carlton S. Dargusch, Tax Commissioner of Ohio, in *Proceedings of the National Tax Association*, 1934, p. 67. Also, R. C. Atkinson, "Tax and Debt Limit Laws," *ibid.*, 1924, pp. 151-163.

²³ A twenty mill constitutional limit became effective in New Mexico in 1934. The net valuation in 1933 was \$285,643,000, and in 1934 it was \$291,890,000. The average tax rate declined from \$3.38 per \$100 in 1933 to \$2.43 in 1934, but the details reveal that the state levy remained the same, those for schools and municipal governments were slightly increased, on the average, while the average county tax rate was reduced almost 46 per cent. Cf. New Mexico Tax Commission, *Report*, 1933-1934, p. 19.

IMPROVEMENT OF THE COLLECTION SYSTEM

Without doubt the weakest aspect of property tax administration has been the collection procedure. Considering some of the deficiencies of assessment, some may regard this as an exaggeration, but it must be allowed to stand. The machinery and procedure of property tax collection were outlined in Chapter XXIII. The problem is naturally that of improving this vital aspect of the tax administration, for it is evident that all earlier administrative steps are futile if the collection process breaks down.

A committee of the National Tax Association, reporting on the subject of tax delinquency, attributed the unusual volume of such delinquency to three major causes: (1) over-assessment, and failure to adjust assessments as property values were deflated during the depression; (2) a faulty collection system; and (3) sheer weight of the property tax, occasioned by high governmental costs, faulty functional distribution, and a restricted revenue system. Ruinous special assessments were also recognized as a contributory factor in some places.²⁴ This analysis indicates that the improvement of tax collection is bound up with all other phases of local fiscal and governmental reform, but there is much that can be done, pending the achievement of a complete readjustment, by way of fixing greater responsibility on the collector, making tax payment easier through installment arrangements, and by clarifying and simplifying various steps in the collection process.

The subject has been dealt with by a committee of the National Municipal League, which drafted a *Model Real Property Tax Collection Law*.²⁵ The essential features of this proposed model law will be briefly outlined, with some running comments on them.

1. Collectors shall be appointed rather than elected, and they shall file an adequate surety bond with the tax commissioner. It is proposed that the appointment be made by the chief financial officer of the taxing district. In Massachusetts the tax commissioner appoints the collectors and their deputies, and thus has a degree of supervisory control over them which is not provided for in the model law. The model law is defective in that it does not contemplate central supervision of collectors, except for the formality of delivering a copy of the official bond to the tax commissioner. It is immaterial whether the tax commissioner or the proposed state department of local finance exercise this supervision, but the authority should be vested somewhere to this end.

2. Real property taxes shall be payable in quarterly installments, and

²⁴ "Preliminary Report of the Committee on Tax Delinquency," *Proceedings of the National Tax Association*, 1932, pp. 292-299.

²⁵ Published as a supplement to the *National Municipal Review*, Vol. XXIV, May 1935.

the form of the tax bill shall be such as to include all taxes levied for state and local purposes in a single bill. Suitable itemization of the levies for different purposes is suggested. The installment plan will permit discontinuance of the discounts now allowed in some states for prepayment, a device which is rightly condemned by the committee as an unnecessary expense to the collecting unit.

3. The tax, with all penalties and costs of collection, is made a lien on the property, paramount to all prior and subsequent encumbrances except subsequent governmental liens.

4. A sliding scale of penalties is proposed for delinquency, rising from one per cent during the first two months from the due date to 10 per cent if paid during the twelfth month. Thereafter, an additional five-sixths of one per cent per month is to be imposed.

5. The receivership plan instituted in Illinois and New Jersey is incorporated. If the tax is delinquent for six months, the collector may apply to a court having jurisdiction for appointment as receiver, ex officio, of the rents and income from the property. This device was developed to deal with conspicuous cases of refusal by the owner or manager of income-producing properties to pay taxes. As a receiver, the collector is authorized to make expenditures from the income to maintain the property in tenable condition, and he is required, after deducting the taxes, to deliver to the court which appointed him any excess of income received, for the benefit of the owner or the creditors, if any. This plan applies only to property that is rented or leased for income purposes.

6. The collector shall sell delinquent properties, at the termination of four months from the close of the fiscal year in which the lien is attached. As explained in an earlier chapter, such sales are often futile because of the liberality of the redemption provisions and the reluctance of the courts to permit property to be taken from the owner in this way. Care has been given to meet all important obstacles. Thus, the sale must be at public auction, after due and rather exhaustive public notice, to the person who will purchase, subject to redemption, at the lowest interest rate not in excess of 12 per cent per annum. The purchaser shall be entitled to semi-annual payment of the interest as stipulated at the sale, and of all subsequent taxes and other municipal liens, since he must pay these later taxes when due in order to keep his own tax title clear. Failure of the owner to meet these payments shall give the purchaser an immediate right of foreclosure of the redemption privilege. If no private purchasers appear, the property may be sold to the taxing district at 10 per cent per annum, and its governing body may thereafter authorize private sale at this rate. The collector shall deliver a certificate of sale to the purchaser, which must be recorded by the register of deeds.

7. The owner may redeem within one year, or at any time thereafter until this right has been foreclosed. The purchaser may foreclose if the

interest and other payments are not made, or at any time after one year. Such action involves a court proceeding, and the owner's defense against foreclosure must be that of paying the interest, and the municipal liens which have been advanced by the purchaser. The draft bill does not state specifically that a clear title shall be given the purchaser after termination of the foreclosure action in his favor, but this is implicit in the right to take such action.

While the bill here reviewed is in many respects helpful, its provisions relative to tax sales are not essentially different from existing laws. The crux of the whole matter is that the sale must occur and that a definite prospect of transfer of title must be given through the foreclosure proceedings. Without central supervision of the collectors, the schedule for holding the tax sales may be neglected in future as it has been in the past. The Massachusetts plan may be cited again, for it makes the collector, and ultimately his bond, responsible for the taxes committed to him for collection. He must collect, make good the deficiency, or take promptly the steps that will evidence his diligence, such as holding a tax sale at the appropriate time.²⁶

One other aspect of tax collection deserves attention. The draft model law properly proposes to consolidate all tax levies into a single tax bill, with details showing the destination of each part of the tax paid, whether to the state, the county, the city, the school district, or to other participating units, but it omits all reference to the procedure that should be observed after the taxes payable on this consolidated bill have been received by the collector. There should be some effective control over the collector's handling of the funds collected until he has transferred them to the treasurer of his district, and over the procedure to be followed by the treasurer in his apportionment of the available tax receipts among the districts represented in the consolidated tax bill. The usual policy is for the treasurer of the collecting district to remit periodically to the several participating units their respective shares. The amount remaining in his custody after these distributions is the share of the collecting district.

If there were always a complete and prompt collection of every tax levy, this method would not be objectionable, but under actual conditions the collecting district is left "holding the bag," and there may be very little left in it after the tax levies of the other units have been paid in full. Especially is this the case during periods of extensive and prolonged tax delinquency, the full impact of which must fall on the district of which the collector is an officer.

This injustice to the collecting district, when it occurs, may be corrected by arranging for proportionate settlements, the proportion of each

²⁶ Cf. remarks of Henry F. Long, tax commissioner of Massachusetts, at the National Tax Conference. *Proceedings of the National Tax Association*, 1934, pp. 384-386. See also, the papers and discussion on tax delinquency, *ibid.*, pp. 320-383.

governmental unit's levy that is delivered to it being determined by the ratio of collected to delinquent taxes. Unless this is done, the otherwise excellent model tax collection law may lead to better collection results for all tax-levying districts except the one responsible for making the collections.

DISPOSITION OF PROPERTY TAX REVENUES

A final problem to be discussed briefly is that of the disposition of property tax revenues. This is a problem of policy rather than of administration. It was prominent in the tax discussion of a generation ago under the heading "Separation of Revenue Sources." This doctrine proposed that local units be assigned certain revenues, chief of which was the property tax, and that the state be assigned certain other, separate revenues. It involved the elimination of a state tax on property for state purposes.

Great virtue was attributed to the plan, in its earlier history, especially as an influence toward more equitable and uniform property assessments, the irregularity and inequality of which were laid to the competition of taxing districts and individuals to escape the state property tax. Adoption of the plan, it was discovered, did not check competitive undervaluation, since the county property tax was usually much heavier than the state tax, and thus provided ample incentive for local undervaluation. On the other hand, separation of revenue sources implied a degree of local isolation and freedom over revenue matters that made more difficult the establishment and maintenance of proper central supervision over assessments. Thus, separation promoted unequal assessment by discouraging efforts at effective equalization.

The problem of policy involved strikes deeper than the superficial and somewhat mechanistic viewpoint of an earlier period assumed. Its essence is found in the question of a proper allocation of governmental service responsibilities, with financial resources adjusted to the relative service load, and in the further question of the best means of establishing suitable and effective supervisory relations between central and local agencies.

Circumstances vary so widely in different states that no general rule can be advanced to determine whether or not the state government should levy a property tax for state use. In any event, a safer keynote would be that of sharing revenues in proportion to responsibilities, instead of segregating them with little regard to the distribution of responsibilities. Advocates of segregation were interested in property tax reduction by the amount of the state levy; but they failed to realize that this levy marked the limit of the tax reduction, if the state were to retain for its own use the whole of the other revenues assigned to it, whereas a plan of

sharing revenues might effect greater local tax savings, even with the state levy still in the program.

Thus, in Massachusetts the state levies a property tax on the equalized valuations of property and polls, the amount being determined by the state budget situation after all other state revenue had been estimated; but it also distributes funds derived from certain state-administered taxes to the cities and towns on the same basis. In prosperous years the local units have received more than a dollar in distributions for every dollar of state tax levied. This system promotes care in state budgeting in order to keep down the state levy, while it gives to the local units the benefit of any unusual productivity of the state taxes. New York has been able to dispense entirely with a state tax on property, and, in addition, to share the yield of certain other taxes with the local units. That this policy has not lessened local property taxes more is due to the retention of an archaic and wasteful local governmental structure, which requires immense sums for its operation. Many states of the south and west retain the state property tax, but they have also been developing systems of grants to local units for education, highways and other purposes.

On the whole, therefore, the conclusion is that the destination of the property tax revenues is less important than some other matters. To be sure, they will always constitute, in part at least, a local resource, but there is no great merit in assigning them *in toto* for local use. Everything depends upon the results of the functional reallocation and upon the volume of other tax revenues that may be available, in a particular state, for the support of public activities. Central supervision and equalization of assessments are state obligations of such importance that they do not require the incentive of a state property tax for their vigorous performance. The principle of revenue sharing in order to get the necessary public work done with the most equitable distribution of the whole tax burden must influence the manner in which the yield of every tax is to be used.

CHAPTER XXV

Commodity Taxes

THE TWO CHAPTERS just preceding dealt with the taxation of things (wealth) under the property tax. In this chapter another method of taxing some of the same things is to be discussed. Strangely enough, the two methods have always been sharply distinguished, yet it is difficult to find anywhere a clear statement of the distinction. The situation illustrates the influence of certain forms and conventions in the evolution of the law and the custom of taxation. The confusion is most pronounced in the case of certain classes of consumers' goods. When things such as radios, automobiles, tires and fur coats are taxed in one way, the result is a property tax; when the same things are taxed in another way, it is an excise tax. Illinois, for example, taxes the above-mentioned articles on their value under a property tax, while the federal government taxes the same articles in the same way, that is, on their value, and it is an excise, not a property, tax.

The principal distinction that would be proposed, probably, is a formal one. Under the property tax all personal property is assessed at once, as of a given date, while under the excise the tax is levied on each unit as it is sold. This does not seem a sufficient basis, since in all other respects the two taxes may be the same. Both are levied on the value of the thing taxed, both are paid by the dealer and will be shifted if possible. In both cases the article is intended for consumption. Nor does it follow that the tax is always a property tax when imposed by the state and an excise tax when imposed by the federal government. The states are taxing various classes of things as commodities rather than as property, and despite the violent opposition in some places to a personal property tax, an excise tax on certain classes of personal property is accepted with entire satisfaction.

It is true that for many commodities the tax is not levied on the value, but on some specific basis such as quantity, but this is not a comprehensive distinction, as the foregoing illustration indicates.

To some extent, therefore, the difference appears to be fictitious rather than real. It is, nevertheless, a convenient one, for it may enable the tax administrator to escape the adverse effects and influences that have rendered one form of taxation unpopular and therefore difficult to apply,

by shifting to another method of accomplishing somewhat similar results which does not suffer from these handicaps.

The convention is convenient, also, in view of the provisions of the federal constitution relative to the apportionment of direct taxes according to the population. In all probability a tax on any kind of property would be construed to be a direct tax. Hence, the federal government could not tax radios, automobiles and fur coats on an ad valorem basis, as property, without apportioning the tax levy according to the population, which would be quite out of the question. Federal excise taxes need not be apportioned, since they are not deemed to be direct taxes. Therefore, the federal government can tax these articles on their value by calling it an excise tax. An illustration was the federal tax of \$5.00 on automobiles during the second World War. It was labelled a "use" tax, and therefore it was an excise. Fortunately it was repealed in 1945.

The word *excise* has no definite meaning in the terminology of taxation. Excise taxes were introduced in England about the middle of the seventeenth century as a means of taxing certain selected domestic commodities. The personal property tax decayed and disappeared in England during this century,¹ and with its decline came the new method of accomplishing somewhat the same results. Dr. Johnson defined the excise as a "hated tax on commodities," thereby registering the popular reaction as well as explaining its nature. The word occurs in the federal constitution but with no explanation of the intended meaning.

It has been customary, among economists, to regard the excise tax as a tax on commodities produced or consumed within the country,² and to accept, unconsciously, the more or less fictitious distinction between it and the property tax. Legal writers and the courts have extended the excise concept to apply, not only to commodities but also to acts and transactions. The editor of the 1924 edition of Cooley's *The Law of Taxation* says: "... if a tax is not a property tax nor a capitation tax it may properly be classified as an excise tax," but this defines neither the property tax nor the excise tax, nor does it distinguish one from the other.³

¹ E. R. A. Seligman, *Essays in Taxation* (1921), pp. 45-47.

² J. S. Mill, *Principles of Political Economy*, Ashley ed., p. 837; C. F. Bastable, *Public Finance*, p. 504.

³ T. M. Cooley, *The Law of Taxation*, 4th ed., edited by C. A. Nichols (1924), p. 125. Judge Cooley had earlier expanded the definition of an excise tax to be one levied "on the manufacture, sale or consumption of commodities within the country, on licenses to pursue certain occupations, and on corporate privileges." *Constitutional Limitations* (1903), p. 680. According to Judson the term *excise*, in the constitutional grant of the taxing power, has been broadened to include practically all taxes, other than customs, which are not direct taxes. F. N. Judson, *A Treatise on the Power of Taxation* (1903), Section 485. There is nothing in this to indicate when a tax on commodities is a property tax, hence direct, and when it is an excise, and hence indirect. Mr. Justice Miller, in his *Lectures on the Constitution* (1891), defined the excise as a "tax assessed on some article of property or money or something which is

Nevertheless, the distinction is made, although few can put it into precise words. Accordingly, in this chapter the various important kinds of commodity taxes used by the federal and state governments, respectively, will be briefly discussed.

FEDERAL TAXES ON COMMODITIES

The federal government has power, under the Constitution, to impose both customs duties and excise taxes. The former applies to goods imported, the latter to internal or domestic production and consumption.

The customs. It is impossible to regard the federal customs or tariff taxes simply as revenue measures, for the reason that neither the rates nor the range of articles taxed have been determined primarily with reference to the revenue that would be produced. From the beginning of the national government, the tariff system has been shaped with a view to regulating the character and direction of industrial developments, rather than for revenue. During the greater part of the national history the motive has been frankly the restriction, even the prohibition, of imports. In executing this policy there has been no definite preconception of the particular channels of industry into which capital and labor should be diverted, to the greatest national advantage, assuming it could be served by such diversion. Protection has been given to all and sundry, the only condition being the ability of the firm or industrial group seeking it to muster enough political influence, openly or secretly, to assure favorable action by Congress.

It is beyond the present purpose to discuss in any detail the arguments advanced to support this mercantilistic policy, or to consider its effects, other than the rather incidental one of the revenue produced. It must be said, however, that the tariff policy since the first World War was an important factor in the financial and trade congestion that became increasingly acute during the ensuing fifteen years. The country had surpluses of manufactured and agricultural products; the Treasury had large payments owing from foreign national governments; during the twenties huge loans were made abroad to finance purchases of American goods, thereby increasing still further the already large aggregate of the foreign private financial obligations to the American people. The tariff barrier was raised shortly after the war and again in 1930. All prospects of substantial payments on public or private debt obligations due here, or of further substantial purchases of raw materials or manufactures, were thereby cancelled. The only means of making large payments, whether

exhausted in the use." "It is," he says, "a tax on consumption." It is equally true that a tax on the retailer's stock of merchandise as personal property is a tax on consumption. Again, there is a failure to distinguish the two, arising from the assumption that a difference exists which needs no demonstration. This assumption cannot be granted.

on debt account or for goods purchased, is by sending foreign goods into the country, and thus the tariff wall effectively restrained. It also made farm relief a certainty, and, as well, the taxation of consumers to provide the funds whereby to replace the profits that agriculture, under a different dispensation, might have obtained from sales to the rest of the world.⁴

Fiscal aspects of the customs. Since customs duties have never been imposed consistently in this country simply upon those articles most likely to move in large and steady volume into the United States, at rates designed to provide a maximum of revenue from the flow, it is not possible to judge the customs system fairly as a source of revenue. As the tariff system has actually operated, it has not been especially satisfactory from the revenue standpoint.⁵ The direction and volume of international trade are determined by various factors in the world price situation, even when there is a minimum of artificial restraints on trade. A certain adjustment to barriers may occur, but the continual change of these barriers, brought about by steady advance of tariff rates, prevents any ultimate adjustment that might otherwise be made, and so prevents achievement of any long-run demonstration of fiscal adequacy.

Other things equal, the volume of customs receipts should rise during periods of rising domestic prices, for it is in such periods that imports tend to increase. Contrariwise, the customs revenue should decline during periods of falling prices, since exports will then tend to exceed imports. But the periods of rising prices provide the occasions when other domestic taxes are likely to be most productive, and vice versa. Consequently, the customs revenue tends to be most abundant when there is least relative need, and to shrink when the Treasury most requires its support.

Any critical situation in world affairs, such as a major war, is likely to affect the volume of foreign trade and hence the productivity of a customs revenue system. In the case of the United States, the munition demand during European wars has led to increased exports, which cannot be taxed. Payment, under such circumstances, is more likely to be made through loans advanced to the buyers rather than through shipments to this country, hence the customs revenue is not likely to be greatly benefited.

Prior to the Civil War the federal government depended mainly on the customs, but it proved to be a highly variable and uncertain basis of financial support. The collections exceeded the ordinary expenditures in some years and fell far short in others. The maximum excess was 89.6 per cent in 1807, and the maximum deficiency was in 1837, when the

⁴ For a comprehensive and lucid statement of the whole issue involved in the protective tariff policy, cf. F. D. Graham, *Protective Tariffs* (1934).

⁵ For a critical discussion of the earlier revenue results, cf. R. F. Hoxie, "Adequacy of the Customs Revenue System," *Journal of Political Economy*, Vol. III, pp. 39 ff. (December, 1894).

customs produced only 29.9 per cent of the expenditures for the year. These transitions from surplus to deficit were unpredictable as well as violent, and they were therefore the more demoralizing.

The development of federal internal taxes after the Civil War provided a more stable element in federal revenue, but it did not offset the marked effect of the ebb and flow of the customs receipts. The large surplus revenues of the eighties encouraged federal extravagance, and the revenue deficiencies of the nineties threatened the gold standard. The federal emphasis upon net income taxation since the adoption of the Sixteenth Amendment and the experience with this type of tax during the depression suggest that one broken reed has been exchanged for another. The severe restrictions on imports under the Tariff Act of 1930 prevented the customs from providing as much revenue thereafter as would have been received had that act materially lowered the duties instead of raising them.

Principles of customs taxation. Should the time ever come when the customs may be considered mainly as a means of providing revenue instead of a political device, there are certain general principles to be observed in shaping it to that end.

First, the number of commodities to be taxed should be few, since the administrative cost is thereby greatly reduced while the revenue is but little impaired if the choice is wisely made. Bastable shows that under the English tariff prior to 1839, five-sixths of the revenue came from nine articles. Three-fourths of the French customs revenue in 1880 were produced by only eight articles.

Second, it is preferable to tax articles of wholly foreign production rather than those produced both at home and abroad. If commodities of the latter sort are included, then the customs duty should be matched by an equivalent internal tax on the domestic portion of the supply. Failure to do this means a bounty to the domestic producers, since the price of the entire supply will be advanced, roughly, by the amount of the duty on the imported portion.⁶

Third, the rates should not be so high as to stimulate undue evasion.

The federal excise system. The present system of federal taxes on commodities originated during the Civil War. In its scope it conforms to the legalistic conception of excise taxation, for it has included at different times taxes on documents and transactions as well as taxes on commodities. For convenience the whole system will be considered here. The similarity of subject matter and the diversity of nomenclature already commented upon is again apparent. Some states tax mortgages by imposing a recording tax. The federal government taxes deeds by requiring a stamp tax to be paid when the deed is recorded.

There were two brief experiments with excise taxation in the early

⁶ Cf. F. W. Taussig, *Some Aspects of the Tariff* (1915), pp. 97-99.

history of the new government.⁷ The first was inaugurated by Hamilton, as a means of providing revenue to meet the charges on the debt, and also, according to Howe, in order to preempt and exercise the powers conferred on the federal government before they should be assumed by the states themselves.⁸ During the decade in which this type of taxation was first employed, a considerable range of articles was levied upon, including liquors, tobacco, carriages and sales at auction. Various legal instruments were also subjected to stamp taxes. The whole system was strongly disapproved. Jefferson characterized it as an "infernal system." One member of Congress denounced it as the "horror of all free states," and another declared it to be "hostile to the liberties of the people." Pennsylvania opposed it most strongly, and one manifestation of the feeling in that section, the Whisky Rebellion, required a display of federal force under the leadership of President Washington. The whole system of excise taxes was swept away in 1802.

The second experiment was made during the War of 1812. The inadequacy of the other sources of federal revenue and the chaotic condition of banking and business during the war compelled resort to these taxes which had been so bitterly condemned but a few years before. The articles levied upon included carriages, sugar, liquors, legal instruments, banknotes, bonds, sales at auction, and license taxes on retailers of wines and liquors. The sudden return of prosperity after the war led to the repeal of all internal taxes in 1817. The administration of the early excise taxes was naturally inefficient, in view of the popular attitude toward them, and their cost of collection was high. The administrative organization devised by Hamilton became the model for later acts, but in neither case were the taxes in operation over a long enough period or under sufficiently favorable conditions to permit the development of a proper administrative technique.

The use of excise taxes in the Civil War began with the act of July 1, 1862. It provided for taxes on malt and distilled liquors; for license taxes on trades; a series of specific and ad valorem taxes on all manufactures, articles and products and on the gross receipts of, or dividends paid by, various classes of corporations. The measure was very diffuse, its avowed object being to levy moderate duties on a large number of objects rather than excessive rates on a few. The rates were advanced and the scope of the act broadened still further by subsequent laws, the most comprehensive of which was the act of June 30, 1864. Still further rate increases were made in 1865, but these contributed little toward the emergency needs. During the next five years the system was gradually contracted and by 1870 many of the most burdensome of the taxes had been removed.

⁷ F. C. Howe, *Taxation in the United States under the Internal Revenue System* (1896).

⁸ *Ibid.*, p. 24.

In 1883 the remaining taxes were withdrawn except those on liquors and tobacco.

The outbreak of the war with Spain was the occasion for the expansion of the internal taxes and for advances in rates. Nearly all of the rates on tobacco and fermented liquors were doubled in 1898, and the system was expanded by the introduction of special taxes on bankers, brokers, proprietors of theaters, bowling alleys, circuses and other places of amusement. Stamp taxes were imposed on a number of transactions involving the use of documents, such as the issue and sale of corporation securities, bank checks, bills of exchange, telegraph and telephone messages, insurance policies and other instruments, as well as on patent medicines, toilet articles, chewing gum and wines. This expansion of the internal revenue system for the purpose of providing additional funds was in refreshing contrast with the methods used during the Civil War. The special war taxes were repealed by 1902.

The first World War affected the federal finances through the disorganization of commerce and the interruption of imports. The act of 1914 (approved October 22) increased the rates on beer and wine, and introduced special taxes on bankers, brokers, theaters and other amusement places, and tobacco manufacturers and dealers. A series of stamp taxes applied to various documents and to cosmetic and toilet goods. This act followed the pattern of the Spanish War excise taxes. The successive war revenue acts extended the scope of the internal taxes by adding taxes on transportation and other facilities of commerce, on admissions and dues, and on a long list of articles of general consumption. With the passing of the war emergency many of these taxes were repealed, and on the eve of the depression the federal excise system had been narrowed almost to its pre-war proportions. The principal elements, after the passage of the act of 1918, were the taxes on distilled spirits and alcoholic beverages, tobacco, and admissions and dues. One remnant of the special war taxes that should have been very productive during the gangster period, the 10 per cent tax on pistols and revolvers, yielded only \$137,900 in 1931. This trifling amount indicated either slack administration or tax avoidance by resort to sub-machine guns.

The fiscal inadequacy of net income taxation during a depression compelled a broadening of the excise tax system. The act of 1932 carried a section on manufacturers' excise taxes and another on miscellaneous taxes. The list of commodities included lubricating oils, automobiles, and parts, tires, furs, toilet goods, jewelry, radios, mechanical refrigerators, sporting goods, cameras, firearms, matches, candy, chewing gum, soft drinks, electric energy and gasoline. Certain other commodities such as coal, crude petroleum, lumber and copper ore were taxed to the extent that they were imported.

The miscellaneous group included taxes on telegraph, telephone, cable

and radio messages, admissions (by lowering the exemption), issues and transfers of bonds and stocks, deeds, sales of produce for future delivery, transportation of oil by pipe line, safe deposit boxes, checks and boats. The tax on checks, candy and boats was eliminated in 1934, and an exempt minimum value was provided for furs (\$75.00) and for jewelry (\$25.00).

The national prohibition act was amended in 1933 to extend the taxes on beer and other non-intoxicating liquors. The agricultural adjustment act of this year provided for so-called processing taxes on certain basic agricultural commodities at such rates, established by the Secretary of Agriculture, as equalled the difference between the current average farm price of the commodities and the fair exchange value. This method of subsidizing agriculture was rejected by the Supreme Court in 1936.

The federal excise system was enormously broadened again during the second World War. These changes were too numerous and complicated to be detailed here. Their fiscal results are indicated in the tabulations which are given below.

Fiscal results of the federal internal taxes. A general view of the yield of the federal internal taxes, except those on incomes and profits is given in Table XXXIX.

TABLE XXXIX

RELATION OF THE FEDERAL INTERNAL REVENUE TAXES TO THE TOTAL ORDINARY EXPENDITURE, BY QUINQUENNIAL AVERAGES *
(THOUSANDS OF DOLLARS)

<i>Period</i>	<i>Average Internal Revenue</i>	<i>Average Ordinary Expenditure</i>	<i>Per Cent, Internal Revenue to Ordinary Expenditure</i>
1863-70	\$ 141,175	\$ 368,442	38.5
1871-75	112,217	335,829	33.3
1876-80	116,696	288,123	40.5
1881-85	132,101	366,981	36.3
1886-90	106,682	375,447	28.4
1891-95	150,208	352,890	42.5
1896-1900	206,623	434,877	47.5
1901-05	255,374	559,481	43.8
1906-10	257,144	628,507	40.9
1911-15	307,155	710,227	43.2
1916-20	875,232	3,363,215	26.0
1921-25	1,039,819	3,263,937	31.8
1926-30	671,331	3,699,941	18.1
1931-35	1,186,497	5,828,222	20.1
1936-40	2,301,995	8,357,432	27.5
1941-45	4,949,105	63,486,842	7.8

* Compiled from the annual reports of the Secretary of the Treasury. Employment taxes collected since 1936 are omitted.

This table compares, by quinquennial periods, the average annual yield of the internal taxes, levied chiefly on commodities, with the average

annual ordinary expenditure, both of which have risen steadily since 1890. The tax yield dropped during the period 1926-1930, because of the restriction of the scope of these taxes and the effect of national prohibition on the consumption of table alcoholic beverages. The period 1931-1935 was abnormal, both as to revenues, which include the processing taxes in 1934 and 1935, and as to expenditures, which were swollen by the agricultural subsidies and large payments for relief and the recovery effort.

It is interesting to note the comparative steadiness of the ratio from 1891 to 1915. There was no tinkering with these taxes during this period, and the emergency levies of the Spanish War proved to be extraordinarily elastic. The tax yield rose with the growth of the country and the normal needs of the federal government. The comparison since 1915 is distorted by the abnormal war and depression expenditures, the prohibition experiment, and the frequent changes of the law. The evidence of the twenty-five years prior to 1915 suggests that a reasonable system of internal taxes is a stable and dependable source of federal revenue, particularly in a depression period such as the early 1890's.⁹

The relative importance of the various federal excise taxes, as the system stood in 1946, is indicated by the distribution of the receipts in Table XL.¹⁰

TABLE XL
RECEIPTS FROM THE FEDERAL EXCISE TAXES ON COMMODITIES AND SERVICES
IN 1946
(THOUSANDS OF DOLLARS)

<i>Tax</i>	<i>Amount</i>
Liquor taxes	\$2,526,165
Tobacco taxes	1,165,519
Manufacturers' excises	922,671
Communications (telephone, etc.)	380,082
Transportation	461,695
Stamp taxes	87,676
Admissions	415,268
Retailers' excises	492,046
Use of motor vehicles and boats	116,142
All other	116,803
Total	\$6,684,178

In Table XL the major excise tax classes are shown. It is significant that all of the miscellaneous objects, together, should produce such a small part of the total. The excise tax system could be greatly simplified

⁹ Such a policy was recommended by The Committee on Postwar Tax Policy, *A Tax Program for a Solvent America*, Ch. 2.

¹⁰ Treasury Release of August 21, 1946.

by eliminating many of these unproductive items with no serious effect upon the revenue yield.¹¹

STATE TAXES ON COMMODITIES

The breakdown of the traditional alignment of federal and state revenue methods, whereby the federal government has made increasing use of taxes on incomes and estates and the states have extended their use of commodity taxes, has already been noted. State policy in this respect has been far from uniform. The two commodity groups that are universally taxed by the states today are gasoline and alcoholic beverages. Instances may be found of the taxation, by one or more states, of various other commodities. This discussion will be restricted to the more important cases of state commodity taxation.

Gasoline. The gasoline tax originated in Oregon in 1919,¹² and spread rapidly among the states thereafter. Within a decade all of the states and the District of Columbia were making use of it. The yield was earmarked for highway purposes during this developmental period. The expanding network of good roads, the amazing reduction in the price of good automobiles, the insensate, competitive self-destruction of the oil industry through overproduction, together combined to cause gasoline consumption to grow by leaps and bounds. This growth, and the tendency of the states to advance the tax rate, have made the gasoline tax phenomenally productive. Even so, this resource plus the accelerating receipts from motor vehicle licenses, and the federal highway grants, was not sufficient to satisfy the demand for road construction, and in the aggregate a huge state and local highway debt was piled up during the twenties. The total gasoline tax collected by the four states that were levying it in 1919 was \$1,022,500. The largest amount collected in one year thus far was \$942,227,000 in 1942.

The rates levied by the states in 1945 ranged from two cents per gallon in Missouri to seven cents in Tennessee, Florida and Louisiana. The rate was three cents in nine states, four cents in eighteen states, five cents in nine states and six cents in five states. Arkansas had a rate of six and one-half cents. In Alabama, Florida, Louisiana, Mississippi, Missouri and New Mexico, counties or cities, or both, were privileged to levy additional rates. The result produced a possible maximum rate of twelve cents per gallon in Alabama and ten cents in Mississippi, including the federal tax of one cent per gallon. The federal tax was introduced in 1932. This is one of the cases of federal taxation in a field already well occupied

¹¹ For a complete list of the commodities and services taxed, see *Annual Report of the Commissioner of Internal Revenue*, 1945, Table 1.

¹² A useful brief survey of gasoline taxation is given by F. G. Crawford, *The Gasoline Tax in the United States*, 1934, Public Administration Service No. 44 (1935).

by the states which prompted the following comment in the second report on the model plan:¹³

After the states had discovered and developed a new and very productive source of revenue in the gasoline tax, and the Federal Government, attracted by their success, had at length imposed a tax on this commodity, criticism was heard from Washington that the states were duplicating federal taxation.

Repeal of the federal gasoline tax, thereby causing it to revert to the states for their exclusive use, was recommended by The Committee on Postwar Tax Policy.¹⁴

The spread of the gasoline tax and the increase of the rates have intensified the administrative difficulties. The retail price of gasoline varies over the country with freight and other differentials, but the tax now constitutes one-fourth or more of the retail price of the non-premium article.¹⁵ Popular resistance has checked some recent attempts at further increase, and Pennsylvania went so far in 1931 as to lower the tax from four to three cents per gallon. Some of the more significant questions of policy involved in the taxation of this commodity will be dealt with briefly.

Exemptions. Under the original theory of the gasoline tax as a source of revenue for highway purposes, it was deemed proper to tax only that which was actually consumed in vehicles making use of the highways. Gasoline used for agricultural and commercial purposes was taxed, and provisions were made, either for an exemption, under which gasoline might be purchased for a non-highway use without payment of the tax, or for a refund of the tax paid when such use was made of it. Sales to the federal government were, of course, exempted.¹⁶

An exemption policy, however handled, is difficult to apply, for the reason that it is impossible to control or verify the use of gasoline, once it is in the possession of the ultimate consumer. The farmer may drive to town with exempt gasoline bought for the tractor, and the dry cleaner may operate his delivery truck with that bought for cleaning purposes. Some states allow no exemption or refund. In view of the ease with which the privilege can be abused, and in view also of the probable extent to which it is abused, the wise policy would appear to be that of eliminating all exemptions and refunds. If some of the tax were appropriated to other uses it could not be said that the farmer and the dry cleaner were being taxed to support highways. If no diversion is made, the allocation of a certain proportion of the yield to the general fund would be proper in order to meet this contention.

¹³ *Proceedings of the National Tax Association*, 1933, p. 413.

¹⁴ *Op. cit.*, Ch. 9.

¹⁵ Crawford, *op. cit.*, p. 45, estimates that in 1933, for every dollar spent, thirty cents was tax and seventy cents was for gasoline.

¹⁶ Confirmed by the Supreme Court in *Panhandle Oil Co. vs. Mississippi*, 277 U. S. 218 (1929).

Collection and incidence. The tax is paid by the manufacturer or distributor. Consequently the state has to deal with only a limited number of actual taxpayers. The universal practice is for the tax to be added to the established wholesale price and finally to the posted retail price. The distributor is reimbursed by the retailer, who is reimbursed in turn by the final consumer. The state laws vary as to their expressed intention regarding the incidence. Some make it clear that shifting to the consumer is intended, others imply that it is a tax on the distributor. The federal income tax regulations have seized upon this distinction, and do not permit individuals to deduct gasoline taxes except in the states that expressly provide for passing the tax along.

Application to highway purposes. The most important question of policy is that of the application of the tax yield. Shall it be dedicated to highway purposes, or is it proper to divert a part to other uses? If the whole is to be devoted to highways, shall it all be used on the state highways, or shall a part be used on local roads? The question of diversion is discussed below.

Unless the state has assumed the financial responsibility for the entire highway network, there can be no doubt regarding the proper answer to the question, so far as it relates to state and local highways. Limitation to the state highway system was proper in the days when the most urgent highway need was an adequate arterial highway system. This need has now been met everywhere, or nearly enough so, that the urgency for further large-scale construction is greatly diminished. About half of the states continue to apply the whole of the tax yield to the state highway system, but the result is likely to be a heavy tax on property for the support of local roads and streets. In many of the states the state highway mileage is only a moderate part of the entire road and street mileage.

The expenditure of the whole of the gasoline tax yield on state highways is likely to result, in future, in extravagance, both with respect to the specifications and to the mileage built. This has been the case already in some states, notably in New Jersey.¹⁷ The other half of the states were sharing the yield, in 1935, with counties or other local units. Until there can be a fairly definite solution found for the problem of the best administrative jurisdiction for road and street maintenance, the automatic allocation of fixed proportions of the yield to all existing local units is almost certain to be a wasteful method of sharing it. Many small townships and boroughs are not capable of operating efficiently as road construction or maintenance agencies. The larger cities are capable, since they will have a competent engineering staff for planning and supervision of street maintenance. As Crawford points out, the cities have fared

¹⁷ Cf. School of Public and International Affairs of Princeton University, *Report on a Survey of Administration and Expenditures of the State Government in New Jersey* (1932), pp. 170 ff.

badly, even with respect to the construction and maintenance of the streets that are essential links in the state highway network.¹⁸

Diversion to other uses. The unwisdom of dedicating any tax to a specific purpose should be sufficiently evident. The reason for this position is that it tends to defeat the important objective of fiscal control through the budget. Assuming this point to be met by establishing suitable budgetary control, it would nevertheless be proper to ask if substantially the whole of the gasoline tax should be appropriated to highway use.

No dogmatic answer can be given. In every state the financial burden of road and street maintenance is such that all of the gasoline tax revenue would hardly suffice. Those who insist upon a rigid application of the original theory of this tax may carry their point by broadening the use of the funds to include the local public thoroughfares. However, if exemptions are eliminated, it would be proper to divert to the general fund a proportion approximating that paid on gasoline used for other than highway purposes.

On the other hand, the advocate of diversion has something of a case, although probably not as strong a case as can be made for highway maintenance as a whole. This case, such as it is, rests on the wide diffusion of automobile ownership and the correspondingly wide diffusion of a gasoline tax among the whole population. In the beginning this tax was paid by a limited group, the motorists, who paid willingly in order to have more improved roads. It was alleged to be improper to tax the motorists, under a gasoline tax, to support schools or other general services.

But the motorists now include so many people that the class taxation argument is undermined. There is now an automobile for every five or less persons in the entire population. There are probably more automobile owners than home owners or beer drinkers. No one has ever objected to taxing property owners or beer drinkers for the support of schools or general government. If there is to be taxation of the people as a whole, the gasoline tax is about as effective a way to assure general distribution of the effects as any that could be devised.

The effects of the peculiar attitude that has been taken regarding the purpose of the gasoline tax, and of the state laws requiring its mandatory use for highways, were rather fantastic in some states during the depression of the thirties. Expensive but relatively unnecessary highway construction continued because the highway departments had the money, while, for lack of funds, schools were closed and the relief burden was

¹⁸ *Op. cit.*, p. 36. The New Jersey Commission to Investigate County and Municipal Taxation and Expenditures proposed that every road maintenance district should be large enough to provide competent engineering supervision, under general state supervision. *Report No. 5. Highway Service and Costs*, pp. 25 ff.

thrown over upon the federal government. This kind of financial management can be regarded only as grotesque.

Alcoholic beverages. The repeal of the Eighteenth Amendment restored the legal status of the manufacture, possession and consumption of alcoholic beverages, subject to determination by each state of the privileges to be allowed within its own borders. A majority of the states hastened to avail themselves of a revenue source that had been cut off by the ratification of this amendment. As part of the argument for repeal, if any were needed other than the abuses that had developed under the prohibition experiment, fantastic estimates were made of the revenue that would be received.¹⁹

The legislation that has been enacted in thirty-two states²⁰ provides for a combination of license taxes on manufacture and sale, and of taxes on the various beverages as commodities. The licenses are not strictly germane to the present discussion of commodity taxes, but the whole subject will be dealt with here for convenience.

Taxes on beverages. The rates imposed on the three major classes of alcoholic beverages—malt, vinous and distilled liquors—are more or less uniform. Beer and other malt liquors are taxed at rates ranging from \$1.00 to \$1.50 per barrel. Vinous liquors are taxed at more diverse rates, and often on a sliding scale which varies with the alcoholic content. The dividing points in this scale are usually 14 and 21 per cent; the first being about the maximum attainable from natural fermentation, and the second, or 21 per cent, being about the maximum attainable by the addition of sugar. Any desired higher percentage of alcoholic content may be obtained by fortifying wines with brandy or other alcohol. The rates range from ten cents to \$1.10 per gallon, but forty to sixty cents is a more typical upper limit for this tax. For distilled liquors the tax ranges from fifty cents to \$1.00 per gallon.

Licenses for manufacture and sale. There is much greater spread and diversity in the licenses collected from manufacturers and dealers than in the taxes on the beverages as commodities. In Iowa and Arizona the manufacturing license is only \$250; but in Michigan the distiller pays \$5,000 and the brewer pays \$50 per 1,000 barrels, with a minimum of \$1,000, Massachusetts collects licenses ranging from \$2,000 to \$5,000, and in New Jersey the brewer pays \$4,000, while the distiller must pay \$7,500. Retail licenses may vary from \$25 in Maryland to a possible \$2,500 in Massachusetts.

Liquor control boards have been established in twenty of the thirty-two states. These issue the licenses to manufacturers and wholesalers, and

¹⁹ This optimism was shared by Congress, for expiration of some of the special recovery taxes was conditioned on repeal or a balanced federal budget, whichever happened first.

²⁰ Cf. summary in *Tax Systems of the World*, 1942, pp. 207-216.

sometimes to retailers, as an aspect of the general control which they exercise. They may also collect the beverage taxes. Retailers are licensed in a number of states by the local governments, but with the supervision of the state control agency when such exists. In a few states the commodity taxes on beverages are collected by the state tax department.

Segregation of the license and the commodity taxes occurs only through allowing the localities to retain such licenses as they may be empowered to issue. Otherwise all revenue is collected by the states, whether for licenses or for taxes on beverages. In general it is kept for state use, but some distributions are made. New Mexico assigns the beverage tax yield to the school equalization fund. New York keeps all license receipts for state use and distributes one half of the tax on beverage commodities locally. Pennsylvania reverses this by retaining the tax and distributing the license receipts. Colorado pays 35 per cent of all license money and 95 per cent of all beverage tax receipts, to the old age pension fund. Wisconsin delivers \$150,000 annually to the school fund, and distributes the remainder on a per capita basis to cities and towns for the reduction of the property tax.

State liquor stores. Sixteen states have undertaken to handle the distribution of liquor through a system of state-owned stores. Wyoming's monopoly system engaged in wholesale trade only. Naturally, in these states only the manufacturers and wholesalers are licensed. The motives for state sale were a desire to secure revenue by absorbing the possible profits of retailing, and in some cases a desire to undertake, by this method, the prevention of certain abuses of the old system. The receipts from liquor monopolies and license taxes are given on p. 204.

A problem of alcoholic beverage taxation. The experience during prohibition indicates the most serious problem confronting federal and state governments alike in the taxation of liquors. This is the danger that through excessive taxation the prices of taxed goods will be forced to levels that will stimulate bootlegging. During the pre-prohibition era the principal zone of illicit manufacture was in the "moonshine" belt, where more than one federal revenue agent gave his life for his country in the effort to locate a picayune still in the mountains. The technique and the financial resources of big business enterprise were applied in the illicit production and sale of liquors during prohibition and the enormous profits realized will not soon be forgotten. Prohibition is impossible by fiat except in communities where it has overwhelming popular support as a public policy. Excessive taxes tend to approximate the restrictions of prohibition and thus to invite the bootlegger.²¹ A similar conclusion

²¹ P. Studenski emphasizes the handicap which the present taxes impose on the legitimate liquor business. He estimates that all taxes and licenses comprise about 60 per cent of the retail price of the cheaper whiskies, and from 20 to 40 per cent in the case of more expensive domestic brands. This burden, together with other overhead

is obvious in the case of the monopoly states, for the bootlegger takes advantage of an excessive price, however it may be established.

State liquor control therefore needs to be tempered with moderation as far as revenue goes. The emphasis of this control should be stronger in some places on the supervision necessary to prevent false branding, to maintain quality, and to cooperate with local authorities in framing and enforcing ordinances relative to sales.

Non-alcoholic beverages. As of January 1, 1942, fifteen states were taxing soft drinks or the materials entering into their manufacture such as syrups, carbonic acid gas, and malt. The rates ranged from two cents to eight cents per pound on carbonic acid gas, and from three to five cents per pound on malt and malt extracts. Fountain syrups were taxed at twenty cents per gallon in Louisiana and at seventy-six cents per gallon in South Carolina. The latter state also taxes bottled drinks at 1 cent for each 5 cents of the retail price. Stamps were used to collect these taxes in twelve states, while monthly or quarterly returns, with payment of the tax shown by the return, were required in the other three states.²²

Tobacco. As of January 1, 1942, twenty-eight states were taxing tobacco products. The cigarette is the object most commonly singled out. The high proportion of the total retail sales value represented by the cigarette justifies the emphasis upon this form of tobacco product, for revenue purposes. State receipts from taxes on tobacco products in 1943 were \$141 million, or a per capita tax of \$1.10.

The tax is administered by the tax commission or department of revenue in nearly all states. In Iowa, the state treasurer is responsible, and in South Dakota the Secretary of Agriculture is in charge. There is simply no way of accounting for the curious things that are sometimes done by legislative bodies in tax administration. Each of these states has a tax commission, but a single minor tax is put off in some other state office where it will cost far more for inspection and supervision than if concentrated with the other taxes. Tax payment is everywhere evidenced by stamps affixed to the packages or boxes. Stamps must be purchased and affixed by the manufacturer, wholesaler or retailer, as the case may be, prior to the first sale of the article inside the state.

All of the states except Georgia require dealers to be licensed, but in Illinois, New York and South Carolina no fee is required, the object being simply to facilitate administration of the tax by having a register of all dealers. Ordinarily the license fee is moderate; but Ohio charges the cigarette wholesaler \$100, and the retailer \$25 annually, while in Iowa dealers pay from \$50 in rural communities up to \$100 in first-class cities.

costs, puts the dealer who pays them at a serious disadvantage. "Liquor Taxes and the Bootlegger," Supplement to *National Municipal Review*, Vol. XXIV, p. 64, at p. 71.

²² This legislation is summarized in *Tax Systems of the World*, 1942, p. 232.

Such rates have a distinct flavor of the prohibition attitude that sought to eliminate the saloon by high license. Rural communities have not wholly accepted cigarette smoking as compatible with morality and the rural element is dominant in the legislatures of all the tobacco tax states with the possible exception of Pennsylvania.

CHAPTER XXVI

Taxes on Acts and Privileges: The Taxation of Business

IN THE primary classification of the groups of taxable objects given in Chapter XIX the term *acts and privileges* was used to include a wide variety of actions, privileges and transactions. From the standpoint of economic significance, that great miscellany of acts and privileges commonly denoted by the word *business*, or the expression *engaging in business* ranks first; and for this reason, the taxes levied on business and on the privilege of engaging in business are paramount in this group. The subject of business taxation is too broad for adequate treatment in a single chapter, or even in a single book. All that can be done here is to discuss in summary fashion certain outstanding taxes on business and the business privilege. In the chapter that follows, some other aspects of the taxation of acts and privileges will be examined.

For example, a business firm pays the ordinary property taxes, just as the householder does. The business concern must pay gasoline tax and motor vehicle licenses, as do all others who use the highways. But in addition to these and other taxes which are paid by all regardless of whether or not they may be in a business, there are other taxes that are levied on business concerns and not on persons who do not engage in business. These distinctive business taxes constitute the present subject matter.

METHODS OF TAXING BUSINESS

The principal methods of taxing business, or the privilege of engaging in business, are on the capital stock, on the gross receipts (or some relatively equivalent term such as gross sales, gross proceeds from sales, and so on), and on the net income. In those numerous cases in which the tax is levied expressly on the privilege of doing business, it may be measured by one of the above-mentioned factors or by some other criterion. The tax on the privilege of doing business, so far as it applies to corporations, is the most important aspect of franchise taxation.¹ But some of the busi-

¹ The corporate franchise embraces several grants. One is the privilege of corporate existence, which is charged for, once, when the charter is issued (this payment is a fee rather than a tax), another is the privilege of acting in the legal corporate capacity; still another is the privilege of doing the thing authorized in the grant of

ness privilege taxes apply universally, as in the case of the retail sales tax (considered in the next chapter). Consequently the idea of business franchise or business privilege taxation is broader in scope than the corporate form of organization. The term *franchise* has had the narrower connotation, however, because the first franchises to acquire both economic and fiscal significance were those granted to the public utilities, which were always organized under the corporate form.

Capital stock taxes. Taxes on capital stock are employed by the states for two principal purposes: first, as a method of continuous, moderate taxation of the corporate privilege, without regard to whether business is engaged in or not. Such taxes are naturally applicable only to domestic corporations, that is, to those chartered by the state imposing the tax and they are ordinarily levied at a small fraction of one per cent on the par value of the outstanding stock. The second purpose is that of providing a basis for taxing both domestic and foreign corporations engaging in business within the state. Every state requires that corporations organized in other jurisdictions go through the formality of applying for permission to do business within its borders. This provides opportunity for registration; and payment of the annual capital stock tax, when such a tax is imposed, becomes a condition for the continuance of the business activity. This type of capital stock tax is applicable, in the case of foreign corporations, only to that proportion of the whole stock represented by the business done in the state. The relative amount of business done is usually crudely measured by the proportion of assets within and without the state, or by the distribution of property owned and gross sales made in and out of the state. Naturally, there is a large measure of self-assessment here, for no state tax department is able to verify adequately the values claimed for property scattered throughout the country. Some states, notably New York and Massachusetts, use this tax as an alternative with the business franchise tax on net income, which means that both are computed and the one that would yield the greater revenue in each case is collected.

Taxes on "corporate excess." The growing prosperity of business corporations after the Civil War, together with the inadequacy of existing tax methods, led to a demand for more effective taxation of the prosperous companies. In response, a special variation of the capital stock tax, known as the "corporate excess" tax, was devised in Massachusetts in 1864, and later copied by some other states. Under this scheme, *corporate excess* means the excess of the market or fair value of the capital stock above the value of the property locally assessed, the property located outside the state and the tax-exempt securities owned. The shares were

corporate powers, e. g., of engaging in the business for which it was organized. Obviously, corporations may continue to exist and to exercise certain restricted rights and powers, without engaging in business.

valued by the tax commissioner, on the basis of market quotations and other information, and the excess of value as thus determined was for a long time taxed at the average rate of property taxation throughout the state. Despite various changes in the direction of correcting the defects originally responsible for this method, it is still used as an integral part of the system of business taxation in Massachusetts, but the rate is now fixed at \$5.00 per \$1,000 of excess value, and a minimum tax, computed at one-twentieth of one per cent of the value of the stock is to be paid if the tax on corporate excess and that on business net income should together produce, for any taxpayer, a less amount.²

This device was necessarily limited to corporations, and consequently failed to correct the deficiencies in property and income taxation in the case of prosperous unincorporated concerns. Strictly viewed, it is a type of supplementary property tax, and it was doubtless so regarded earlier, in Massachusetts and in the other states that adopted it, for the general rule has been to tax the corporate excess at the usual rates applicable to other property in the same taxing district. But the present viewpoint in Massachusetts and Illinois, which afford the only important existing illustrations of this tax, regards it as part of the system of business excise taxation.

Such a tax is difficult to administer, especially in the case of the large number of corporations the stocks of which are not listed and dealt in actively on an exchange. Stock values are largely determined and influenced by earning power, present and prospective, and it would seem that a suitable adjustment of the tax on business net income would accomplish every purpose that is attained by the tax on corporate excess. The chief argument that might be urged for this tax, and for the capital stock tax generally as a form of business taxation, is as an alternative minimum to the business franchise tax on net income, serving to determine minimum tax liability and thus to safeguard the revenue against abnormal fluctuations.

An ingenious new variation of the corporate excess tax was introduced in New Jersey in 1945. The incentive was to find a solution for the troublesome problem of intangible property which had been exposed for years to an especially virulent form of "Jersey lightning." Raids had been conducted against large companies by hard-pressed municipalities which had forced many of them to establish "tax colonies" at Flemington and other places, as a means of gaining sanctuary for their intangible assets. The solution, as enacted, may be summarized from the report of the special investigating commission which proposed it:³

² For further details, cf. *General Laws Relating to Taxation*, 1940, Ch. 63. The Illinois capital stock tax is also a tax on the corporate excess. Cf. *Report of the Illinois Tax Commission*, 1939-1940, Ch. V.

³ *Report of the Commission on Taxation of Intangible Personal Property*, Trenton, 1945, p. xiv.

First; That the present methods of taxing intangible personal property be abandoned.

Second, That intangible personal property be exempted entirely from local taxation, except for the present special taxes relating to banks, insurance companies and public utilities.

Third; That the Legislature provide a corporation business tax, in lieu of all other State, county, or local taxation measured by intangible personal property used in business, and in place of the present capital stock tax.

Fourth: That such corporation business tax shall require that every domestic or foreign corporation subject to the taxing jurisdiction of New Jersey (except some at present exempt and others specially taxed) shall pay an annual franchise tax for the privilege of having or exercising its corporate franchise in this State or for the privilege of doing business, employing capital or maintaining an office in this State;

Fifth: That such franchise tax shall be paid annually by each taxpayer and shall be measured by the greater of the following:

Alternative 1 (Basic measure): that portion of its entire net worth as may be allocable to New Jersey according to the average ratio of tangible property, gross receipts, and wages and salaries, respectively, in the State, to such items everywhere; or

Alternative 2 (Minimum measure): that proportion of its entire net worth as its total assets, tangible and intangible, in this State are to its assets, tangible and intangible, everywhere.

Rates under alternatives 1 or 2: $\frac{1}{10}$ of a mill upon the 1st \$100 million of allocated net worth; $\frac{1}{10}$ of a mill upon the 2nd \$100 million; $\frac{3}{10}$ of a mill upon the 3rd \$100 million; and $\frac{2}{10}$ of a mill upon all amounts of allocated net worth in excess of \$300 million.

Alternative 3 (Minimum tax): But not less than \$25.00 in the case of domestic corporations and \$50.00 in the case of foreign corporations.

The federal capital stock tax. During the first World War, and again during the depression years following 1929, the federal government resorted to the taxation of business by means of a capital stock tax. In both cases the tax was declared to be imposed with respect to carrying on or doing business, that is, it was a business privilege tax; but the two experiments differed radically on an important point of procedure. Under the first, which was introduced by the Revenue Act of 1916,⁴ the valuation of the capital stock was made an administrative task, while under the second, enacted in 1933, the corporation was required to declare the value of its own stock, with no provision for audit or review. Foreign corporations were taxable, in both periods, on the capital stock employed in the business done in the United States.

The administrative problem presented by the first tax on capital stock was stupendous. Although a return was made by each corporation, the bureau in charge was supposed to examine it and make a formal assessment on the basis of its appraisal of the entire value of the company. About

⁴ At the rate of fifty cents per \$1,000 of capital stock value, with a flat deduction of \$99,000; the act of 1918 raised the rate to \$1.00 per \$1,000 and lowered the exemption to \$5,000.

340,000 returns were handled annually, which meant that more than 1,000 complete appraisals had to be made in each working day of the year. Evidently the office "audit" and appraisal were almost wholly formal, and equivalent to self-assessment. This tax was repealed by the Revenue Act of 1926.

When it reappeared, in 1933, the administrative difficulties of valuation were neatly sidestepped by requiring that corporations were to report their own respective "adjusted declared values of capital stock."⁵ It was originally provided that any such declaration, once filed, was not subject to later change except in consequence of changes in capital during a subsequent year. This prohibition was not retained, and from time to time revised declarations of capital stock were authorized.

Had this measure stood alone, the situation would not have differed greatly from that under the act of 1916, for self-assessment must have prevailed then in large degree. But it did not stand alone. As a complementary tax, an illegitimate excess profits tax was also introduced, levied on the amount of net income in excess of a certain percentage of the declared stock value.

There was no good defense for either of these taxes. The case for a capital stock tax is best when it is used as an alternative, minimum tax payable if there is no net income. But if a corporation anticipates small or only moderate earnings and hence has no occasion to fear the excess profits tax horn of the dilemma, there is both opportunity and incentive to set an absurdly low value of the stock. Thus it may not operate well as a minimum tax while self-assessment is allowed. On the other hand, if substantial earnings are anticipated, careful calculation is required to forecast the stock valuation that will produce the minimum tax. A considerable amount of managerial energy went into this problem that would better have been devoted to other matters. The so-called "excess profits tax" of 1933 was in no respect what it purported to be, for an artificial, arbitrary declared value of the capital stock is obviously an improper base for the measurement of either normal or excess profits. Repeal of both taxes was advised by the Treasury in 1942, and accomplished by the Revenue Act of 1945.

Taxes on gross receipts. A second basis for the imposition of business privilege taxes is the gross receipts from the business. This use of the gross receipts base must be distinguished from that encountered when gross receipts are taxed in lieu of a tax on the property. The "in lieu" type of gross receipts tax is used by some states for the taxation of the various classes of public utilities. While such cases do not constitute

⁵ This tax was introduced by Section 215 of the *National Industrial Recovery Act*. Corporations exempted from income tax by section 103 of the revenue act of 1932 were excluded, as were also insurance companies and all corporations not engaged in business.

property taxation in the strict sense, they belong in this category rather than elsewhere by reason of the purpose underlying the substitution.

Gross receipts serve also as a basis of business privilege taxation in the case of both public utility and ordinary business corporations. Ohio uses the intrastate gross receipts of utilities as the basis of an excise tax on the privilege of doing intrastate business. New Jersey levies a franchise tax on the proportion of gross receipts of public utilities corresponding to the relative valuation of utility property in public rights of way. Other instances of business privilege taxation based on gross receipts are the taxation of motor common carriers in several states, manufacturers in Delaware, private bankers in Pennsylvania, boxing bouts in Michigan and Wyoming, and the occupation license tax in Louisiana.

The term *gross receipts* means the receipts from the business, the privilege of conducting which is to be taxed. Unless definitely restricted in meaning, it could include receipts from investments and from non-operating property, whereas the privilege taxed is that of conducting a particular type of business such as a utility. Legislatures are sometimes careless in such matters,⁶ and expression such as "business done" or "volume of business done" may be found, when the context obviously means that gross receipts are intended.

The gross receipts base must be limited to the receipts from the business done within the state, when it is used for privilege tax purposes. When it is used as a substitute for a tax on property, an apportionment of the receipts from interstate business on some equitable basis such as mileage, is permissible, but this is only because of the fact that the property in such cases is not taxed directly as such. Taxation of interstate gross receipts, in addition to the taxation of the property, would constitute an alleged burden on interstate commerce. A comparison of the California law prior to the change made in 1934, and of the Ohio utility excise tax law, will illustrate the two methods of determining taxable gross receipts.

In the field of utility taxation, there is a case for this type of privilege tax, particularly in the states in which, historically, the local units have been accustomed to rely on local taxation of utility property. It provides, in such instances, a means of sharing the whole amount of taxes collected from these businesses between the state and the localities. The simplest case occurs when the utilities are taxed solely by the gross earnings method, for it is then possible to apply one rate on the state's share of all gross receipts as in lieu of the property tax, and another on the intrastate receipts as a franchise tax. The yield of the former could be distributed to the localities in which the property is situated, and that of the latter could be kept in the state treasury. This system would safeguard local

⁶E. g., in *Laws of the Territory of Hawaii*, Code of 1930, Ch. 69, three terms were used to mean the same thing: *gross income* (Section 2140); *gross receipts* (Section 2142); and *gross earnings* (Section 2143).

revenues, but it would also diminish the evil effects of local gerrymandering of districts so as to include utility property, and of the accident of the location of large utility properties in small districts.⁷ The two rates could be adjusted so as to give equal revenue to state and localities, or in any other desired proportion.

Retention of the property tax on utility property while adding a franchise or privilege tax on intrastate gross receipts is more complicated, chiefly on account of the method that is likely to prevail with respect to disposition of the property tax. In Ohio utility property is assessed by the tax commission and the valuations are certified to the local districts for taxation at the local rates. The state collects, in addition, an excise tax on intrastate gross receipts. This plan compels the corporations to settle hundreds of separate small tax bills in the several districts in which their properties are located. The defect could be corrected by levying the property tax at the average state rate, as in Wisconsin and New Jersey (for railroad and canal companies). The tax would be paid to the state in a lump sum, and the state treasurer could then distribute the yield in proportion to the utility valuations in the several districts. As long as the property tax base is used for public utilities, with local allocation of the bulk of the tax, it will be difficult to limit the local abuses arising from district boundary manipulation and the accident of property location. The combination of franchise and in lieu taxes on the gross receipts of utilities is a more effective way of combating these abuses.

The gross receipts basis for ordinary business. Gross receipts are not commonly used as yet as a basis for the taxation of ordinary business (as distinguished from the public utilities). It is true that the sales taxes that have sprung up are usually imposed as license taxes, based on the privilege of selling and measured by the volume of sales; but many of these laws contain provisions forbidding the dealer to absorb the tax, or else positively requiring him to extend the tax as an addition to the regularly established price. In such cases the tax is supposed to be borne by the ultimate consumer. The dealer is merely a tax collector and the license device is introduced simply as a control feature. The burden of any gross receipts tax may be in part on the consumer of the product or service, and it will be if shifting can be successfully practiced, but such shifting is not mandatory in the tax law except in the case of the sales taxes.

Insurance companies. The equivalent of gross receipts is the principal basis of taxation in all states for one important kind of business, namely, insurance. In this case it is the gross premium receipts, from which certain deductions, such as returned premiums, other refunds, reinsurance ceded,

⁷ Cf. H. L. Lutz, *The Tax System of Maine*, p. 109. In 1932 Portland had an electric utility property assessment of \$335,000; but the town of Pleasant Ridge (population, 104 in 1930) assessed electric company property at \$2,750,000; the town of Moscow (population, 1,455) at \$2,588,500; Gorham (population, 3,035) at \$1,036,000.

and dividends to policyholders, are permitted. Analogous deductions would be permitted under any kind of gross receipts tax. Insurance companies are also taxed on their real property such as office buildings, but this constitutes a small part of the total taxes paid. The rates range from 1 to 3 per cent, and the average is probably somewhere more than 2 per cent. Foreign companies are usually dealt with on a reciprocal—or retaliatory—basis.

Chain stores. During the wave of opposition to chain stores, at least five states sought to tax the gross receipts of such stores. The method employed was to graduate the tax according to the volume of receipts. In each state the courts held such a tax to be unconstitutional. Chain stores are subject to special taxation in about 20 states, but in all cases except one the tax is a graduated license, the amount payable being determined by the number of units in the system.

License taxes in the South. The southern states generally have developed elaborate systems of business license taxes. This whole development is characterized by excessive detail, arbitrary and illogical classification of business enterprises, and confusion between the purposes of police regulation and taxation for bona fide revenue purposes.⁸ Louisiana has used the volume of gross receipts extensively as the basis of the tax schedule, but the Louisiana law is subject to all of the comments just made on southern license taxes generally. In Louisiana each business or occupation is taxed separately, with long and minute classifications on the basis of the volume of gross receipts. The municipalities are permitted to levy local license taxes on the same basis, but in amounts not exceeding those of the state tax.⁹

Taxes based upon business net income. A third important base for the taxation of business is the net income. In practice, this form of business taxation is applied only to corporations. All of the states except New York which employ the income tax for the taxation of persons and which also tax business on the income basis follow the practice of the federal government in taxing the business income of partnerships and sole proprietor concerns to the individuals receiving it, instead of taxing the business as such. New York taxes the net income of unincorporated business in a manner parallel to that applied to corporations.

There is a widespread, though mistaken, impression that corporation income is virtually the whole of business income, and that the basic distinction in the tax program is one between corporation income, which is business income, and individual income, which is drawn from other sources. The error in this belief was exposed by The Committee on Post-war Tax Policy, which presented data indicating that the net profits

⁸ Cf. H. L. Lutz, *The Georgia System of Revenue*, pp. 51, 52.

⁹ Cf. Louisiana *General License Law*, Act 15 of the Third Extra Session of 1934, as amended by Act 5 of the First Extra Session of 1935.

reported by individuals and partnerships averaged, over a twenty-year period, fully half as much as the net income reported by corporations. In part the former included personal drawings or other compensation for personal services of the owners, but the significant thing about such income is that capital is contributory to the total. The persons reporting were engaged for the most part, in some business activity, since the proportion of strictly professional earnings in the total was small.¹⁰

One problem of tax policy which as yet remains unsolved is whether or not to identify all business income as a homogenous entity, to be exempted as such or to be taxed as such, or to continue the historic differentiation between corporations and all other taxpayers. All business is a means to an end, regardless of the form of organization under which it is conducted. Somewhere there are individuals who receive the income, suffer the losses if any, and make the decisions with respect to the distribution of income or its retention for use in further business operations. From this viewpoint, it would appear logical to exempt business income as such, and rely upon the individual income tax.

A difficulty would still remain, however, with respect to undistributed business income, for it would not be taxed at all under such an arrangement. Even this would be logical and permissible if the income retained were always needed and always used for proper business expansion purposes, since its investment would promote a larger flow of earnings, and hence, eventually, of distributions. But the practical aspect of this situation would be the possibility that earnings were being retained merely in order to enable large stockholders of corporations to avoid heavy income taxes. The only feasible solution which has been proposed by those who advocate the exemption of corporations is a tax on undistributed income, a topic which has been highly irksome to business men since the experiment with an undistributed profits tax in 1936-38. Moreover, the exemption of corporations would constitute a grave discrimination against unincorporated business.

The historic policy has involved a discrimination as between corporations and unincorporated business, the burden of which may fall in one direction or the other. Corporations pay a tax on net income, the rate of which has risen from 2 per cent in the act of 1913 to 40 per cent in the laws effective from 1941 through 1945. The unincorporated business is not taxed as such, but the owner, or owners, must report their respective shares of the entire income for taxation under the individual tax rates, whether such income has been distributed to them or not. Since 1935 individuals have been fully taxed on dividend income. When the corporation rate is 40 per cent, or even 38 per cent, this means that a dollar of income before taxes is taxed at 38 per cent to the corporation, and at another rate which may range from 20 per cent to 80 per cent if it is

¹⁰ *A Tax Program for a Solvent America*, New York, 1945, Ch. 5.

paid out in dividends. The combined taxes never exceed 100 per cent because the individual computes his tax on that part of the dollar of income which he receives after the corporation tax is paid.

But this additional tax is paid by the individual only on what he receives. The income retained is taxed only at the regular corporation tax rate. The proprietor or partner must pay the surtax rates on his share of the total income, whether he takes it out or leaves it in the business. Even so, the person who receives only a small income from a business will not pay as much as 38 per cent on any of it; but he who receives a substantial amount from a business will pay much more than 38 per cent on that portion in excess of some \$13,000 (under the 1946 rates). It is therefore much more burdensome for such a person to set aside part of his business income for expansion purposes than it is for the corporation. The more the corporation tax rate is reduced, the greater this kind of discrimination becomes.

One solution would be to establish the same rule for all forms of business income, namely, that the entire net income be taxable at some flat rate, and that only such part as were distributed, whether as dividends to stockholders or as personal drawings or compensation of proprietors and partners, be taxable at surtax rates. The administrative difficulties would be considerable, because of the large number of small individual firms and partnerships and the ease with which funds can be manipulated between the firm's accounts and those of the owner. These difficulties have no doubt been influential to preventing legislative recognition of the logic of the case.

For the practical reasons which have been indicated, the discussion of the taxation of business income must be restricted here to the tax treatment of corporation income. The federal income tax, as applied to corporations, has become so much more important than the state taxes as to warrant correspondingly full attention to this tax.

THE FEDERAL CORPORATION INCOME TAX

Some aspects of the general subject of income relate to both individuals and corporations. In part, these matters have been dealt with in Chapters XX and XXI. Examples are the rules for depreciation and depletion, the treatment of business net losses, and certain applications of the tax on capital gains. There are a number of special rules relative to purely corporate transactions, such as the cases in which gain or loss is or is not recognized in connection with corporate reorganizations of various types. These rules are technical and are not dealt with here.

The corporation tax rates. Three different levels or plateaus of corporation income tax rates may be distinguished. The first extended from 1913 to 1917, and the rates were low, beginning with 1 per cent in

the 1913 act and rising to 4 per cent in 1917. The act of 1918 raised the rate to 12 per cent, and thereafter to 1936 it varied in different years between 10 per cent and 15 per cent. Some further increases brought the rate to 19 per cent in 1939. The third level was attained in 1940, with a normal tax rate of 24 per cent and the introduction of a corporate surtax, which was eventually advanced to 16 per cent, making a total tax rate of 40 per cent on corporate income. The act of 1945 reduced the surtax rate by 2 per cent.

The device of a surtax was introduced in order to provide an increase of the corporation tax without increasing the advantage enjoyed by the recipients of interest on partially exempt federal bonds. Under the terms of this exemption, the interest was exempt from the individual normal tax, and from such tax, analogous to the normal tax, as was levied upon corporations. This had meant exemption from the ordinary rate of the corporation tax. Stated briefly, the distinction was effected by defining normal tax net income and surtax net income in different terms. The former was defined as the net income minus the credit for dividends received (85 per cent of such dividends) and minus the interest on partially tax-exempt bonds. The latter was defined simply as the net income minus the dividends received credit. Thus the tax-exempt interest was excluded from normal tax and included for surtax purposes.

The post-war problem of tax revision will include careful decisions with respect to the proper corporation tax rate. There has been no peacetime experience with a tax rate higher than 19 per cent, and for the greater part of income tax history the rate has been well below that point. Under the act of 1945 the tax rate is to be 38 per cent. Such a rate may not be unbearable for strong, established companies, but it would place new, growing companies in a disadvantageous position. The Committee on Postwar Tax Policy recommended, as a goal, an equality between the corporation rate and the initial rate on individual incomes. It was recognized, however, that revenue requirements might defer for some time the attainment of this goal.¹¹

Intercorporate dividends. Until 1935 the dividends which one corporation received from its holdings of the stocks of other corporations were excluded from the income return of the first corporation. The theory underlying this exclusion was that the corporation paying the dividend had already been taxed on its entire net income, hence to tax such receipts to the receiving corporation would be double taxation. In 1935 corporations were permitted to exclude only 90 per cent of dividends received, which meant that there was double taxation of the other ten per cent. This percentage was later reduced to 85 per cent. Certain dividends are not to be excluded, such as those paid by domestic corporations deriving

¹¹ *Ibid.*, pp. 127, 128.

a large part of their gross income from sources within a possession of the United States, tax-exempt corporations, and foreign corporations.

The denial of complete deductibility of dividends paid by corporations fully subject to the federal tax was part of the attack on holding companies which was waged in various forms during the 1930's. The Committee on Postwar Tax Policy recommended in 1945 that this form of double taxation be eliminated.¹²

The consolidated return. Prior to the enactment of the 1934 act, affiliated companies had the privilege of making consolidated returns. Virtually complete affiliation was required before a consolidated return would be accepted, but when this was possible it was of material advantage to all of the companies concerned. A consolidated return is one made by the so-called "parent" or top holding company of a group. The profits and losses of the constituent companies are all carried through to the accounts of the parent company, and the losses of the weak units are thus offset against the profits of the strong units, thereby reducing the final amount of net income shown by the reporting company. If the affiliation embraced both strong and weak units, and such was likely to be the case when extensive and rather indiscriminate combinations had been carried through under liberal holding company practices, the consolidated return was a decided advantage from the taxation standpoint. The act of 1932 had imposed an additional $\frac{3}{4}$ per cent tax on the consolidated return if it was made, but this slight increase of tax rate was not a full offset against the advantage of making it. Under the 1934 act, the privilege was withdrawn except in the case of railroad companies, and if the affiliated groups in this field elected to make such a return the net income shown therein was taxable at a flat rate of $15\frac{3}{4}$ per cent. This rate was retained in the act of 1935. Affiliated companies were again permitted to file consolidated returns of the act of 1942, on payment of an additional tax rate of 2 per cent.

The Committee on Postwar Tax Policy offered the following recommendation on the subject: ¹³

We favor the elimination of the 2 per cent differential in the income tax charged against corporations for the "privilege" of making a consolidated return. The principle of the consolidated return is now recognized in the law as contributing both to simplicity of compliance and accuracy of the income return. The taxpayer gains in his management decisions, and the Treasury gains by having before it a statement which accurately reflects the income of the group. In this *quid pro quo* there is no reason for imposing a tax rate different from that which would be paid if the several companies were to file separate returns.

Insurance companies. A third feature of the federal corporation income tax is the separate treatment of insurance companies. This does not extend

¹² *Ibid.*, p. 146.

¹³ *Ibid.*, p. 147.

to the tax rate, which is the same as that applied on the income of other corporations; but the nature of the insurance business is such that a different method of determining taxable income is required.

Improper accumulation of surplus. A fourth feature is the additional tax on corporations that improperly accumulate surplus to enable stockholders to escape payment of surtax. This device was first used in 1917, at a rate of 10 per cent on all net income remaining undistributed six months after the close of the company's fiscal year, except that actually invested or retained for use in the reasonable conduct of the business, or for investment in the obligations of the United States. It was dropped from succeeding acts until 1928, when it reappeared in far more stringent form. The rate was raised to 50 per cent of the entire net income, in addition to the ordinary corporation tax, and the fact that a corporation was a mere holding or investment company, or that the income was permitted to accumulate beyond the reasonable needs of the business, was declared to be *prima facie* evidence of an intent to escape the surtax. This penalty tax was not imposed, however, if the several shareholders had reported their respective distributive shares of the net income for the year in question.

The act of 1934 relaxed this penalty upon the advice of the Ways and Means Committee that the 50 per cent penalty was not readily enforceable.¹⁴ Under the present law, if a case is made that a corporation has been formed or availed of for the purpose of evading the surtax, a tax is imposed on the "adjusted net income" at 27½ per cent of the first \$100,000, and 38¼ per cent of the remainder. Adjusted net income is defined as the net income including dividends from other companies, less dividends paid.

The Committee on Postwar Tax Policy concluded that the matter of earnings retained for tax avoidance would not be a problem of great importance in the post-war period. It took the position that in the case of ordinary business corporations, the management should be free to make decisions respecting accumulations and that the bureau should give much more weight to managerial judgments as to what earnings should be retained than has been the case in the past. This position was based on the belief that, in the great majority of cases, the decision of management is made primarily on legitimate business reasons and not with a view to shielding certain stockholders.¹⁵

Personal holding companies. The personal holding company was differentiated and defined as one deriving at least 80 per cent of its gross income from royalties, dividends, interest, annuities, and gains from the sale of securities, and having, at any time during the last half of the tax-

¹⁴ *Preliminary Report of a Sub-Committee of the Committee on Ways and Means, "Prevention of Tax Avoidance,"* p. 8, 73rd Congress, 2nd Session, 1933.

¹⁵ *Op. cit.*, p. 138.

able year, more than 50 per cent of its outstanding stock owned by not more than five individuals. The additional tax is imposed on the undistributed adjusted net income, at 75 per cent on the first \$2,000 and 85 per cent on the remainder. Few additional personal holding companies are being formed and most of those in existence are being dissolved as rapidly as possible. In 1941 there were 5,501 personal holding company returns, a decrease of 229 from the number made in 1940. Of the number reporting in 1941, 5,187 had no undistributed net income; 314 had undistributed net income totalling \$1,143,054, on which the special taxes amounted to \$1,001,707. It is clear from this record that very special reasons must exist to warrant the maintenance of a personal holding company.¹⁶

Some special cases. Finally it should be noted that special treatment is accorded to corporations under various circumstances. Corporations organized under the China Trade Act of 1922 are allowed a credit against net income of an amount equal to the proportion of the net income derived from sources within China which the par value of the shares owned by (1) residents of China, the United States or its possessions and (2) individual citizens of China and the United States, wherever resident, bears to the whole par value of the outstanding stock, except that the diminution of tax by this credit shall not be greater than the amount of the special dividend paid to shareholders during the year. Such corporations shall not be deemed to be affiliated with any others, nor are they allowed credit for income taxes paid to foreign countries.

Domestic corporations are permitted to credit income and excess profits taxes paid in foreign countries against the tax due here, and foreign corporations are taxable only on the income derived from sources within the United States, but are not permitted to credit against this tax the income taxes paid in other countries. Corporations (and individuals) deriving a major part of their gross income from business done within a possession of the United States, are required to report only the gross income from sources within the United States, but if they take advantage of this section they are not allowed credit for income taxes paid to foreign countries.

The taxation of undistributed earnings. The policy of the tax law with respect to corporate earnings found to have been improperly retained for the purpose of enabling stockholders to avoid surtax has been outlined. But the question of proper or adequate taxation arises, even with respect to earnings which have not been retained for tax avoidance purposes. As noted earlier, this question becomes the more acute if consideration were to be given to the proposal to exempt corporations entirely from income tax. It is clear, of course, that as long as the total corporate income is taxed, at some rate, there will be taxation of the income retained as well as of that distributed.

¹⁶ *Statistics of Income for 1941, Part 2, p. 32.*

The issue has been raised by those who would carry the perfectionism of the individual income tax to the ultimate. They contend that the several stockholders of a corporation are the owners of their respective proportionate parts of the entire net income, whether it is distributed or not. Hence, if only a portion of the net income is paid out in dividends, the stockholders escape individual tax to the extent of the retained share. This contention is made quite apart from the cases in which the retention may be found to have occurred deliberately for the benefit of stockholders. The conclusion is reached, from this line of argument, that the stockholders benefit from the retention and use of earnings in a degree which cannot be covered through their individual taxes, and that there should be some kind of compensatory tax levied on the undistributed profits, whatever be the reason for their retention.

The Committee on Postwar Tax Policy replied to this contention, in summary, as follows: ¹⁷

1) The inclusion of pro rata shares of undistributed income is neither sound nor feasible if the test of liability for income tax is to be realization of income. Obviously, undistributed corporate income is not realized income to the shareholder.

2) Except in liquidation the shareholder has no legal title to earnings, and even then there is no prior claim. While reinvestment of earnings tends eventually to increase the value of the stock, it does not follow that the market price will necessarily be increased. Other factors may counteract the rise, or it may mean that the expenditure was necessary to prevent a decline of value that would otherwise have occurred.

3) A capital gains tax will be paid if the stock is later sold, or an estate tax if it is held until death. The distribution of retained earnings during depression years will tend to support stock values and prevent the realization of capital losses.

4) The attempt to establish a theoretical parity of individual tax contributions involves the assumption that constructive receipts (such as undistributed corporate earnings) indicate taxpaying capacity as definitely as do actual receipts (such as salary, interest, cash dividends, etc.). Under this assumption, if no cash dividend were received, the stockholder with no other income would have to sell some of his stock to pay a tax levied on income which he never received.

In 1936 an experiment in the taxation of undistributed corporate profits was tried. Profits not distributed were taxed at rates ranging from 7 to 27 per cent. In 1938 the Ways and Means Committee summarized the complaints brought against the tax as follows: ¹⁸

1. The surtax discourages, in many cases, legitimate business expansion, and, therefore, has an adverse effect on employment.

2. It puts a penalty on corporations which find it necessary to use current earnings in the payment of debt.

¹⁷ *Op. cit.*, pp. 142-144.

¹⁸ *H. R. 1860, 75th Congress, 3rd Session*. Reprinted in *Internal Revenue Bulletin, Cumulative Bulletin 1939-1, Part 2*, pp. 728 ff.

3. It burdens the small and weak corporations more than the large and financially strong corporations.
4. It is unfair to corporations with impaired capital which under State laws cannot legally declare dividends.
5. The relief provisions applying to corporations having contracts not to pay dividends or requiring the use of current earnings for the payment of debts are so restrictive as to provide relief only in rare cases, although many other cases equally meritorious receive no relief.

Despite this array of criticisms, the Ways and Means Committee pronounced the tax sound in principle. This position was directly opposed by the Senate Committee on Finance, which stated in its report on the revenue bill of 1938 that the principle of the undistributed profits tax should be entirely abandoned.

The taxation of excess profits. During the first World War, and again during the second World War, the federal government resorted to taxes on so-called "excess profits."¹⁹ War conditions involve possibilities of enlarged profits for many business concerns, and the war financial need demands large revenues. A tax on excess profits is the logical development to meet both circumstances.

The first question to arise is: What is an excess profit? It should be noted that the term *excessive profit* is not used. The latter term involves judgments, or opinions, or ethical connotations. The former term merely purports to determine the profit that is in excess of some standard amount. The major point, therefore, in a tax on excess profits is the standard by which the amount of excess is to be measured.

The excess profits tax system that was developed during the second World War established two standards for the measurement of excess profits. One was the average earnings of a base period, the other was the invested capital. The base period chosen was the years 1936-1939. Various methods of constructing the average were developed, illustrative of which were the following: the taxpayer was permitted to substitute for the earnings of his poorest year 75 per cent of the average earnings of the other three years, if he used the general average method. If he employed the growth method, his average was to be based on actual experience. The emphasis upon growth was permitted as a basis of establishing that a general average was not a fair test. In this case period earnings were to be taken as the average of the last two years plus one-half of the excess of that average over the average of the first two years. The amount of the credit under any averaging method was to be 95 per cent of average base period net income, plus 8 per cent of any net increase, or minus 6 per cent of any net decrease, of invested capital after the close of the base period.

The invested capital credit was determined as a series of percentages

¹⁹ For a good account of the excess profits taxes imposed during the first World War, cf. Kenneth James Curran, *Excess Profits Taxation* (Washington, 1943).

of different amounts of invested capital. As the law stood in its last year, 1945, these percentages were:

<i>Invested Capital</i>	<i>Credit</i>
Not over \$5,000,000	8 per cent of invested capital
Over \$5,000,000 but not over \$10,000,000	\$400,000 plus 6 per cent of the excess over \$5,000,000
Over \$10,000,000	\$700,000 plus 5 per cent of the excess over \$10,000,000.

Invested capital was defined to include money and property paid in for stock, as paid-in surplus, or as contributions to capital, plus accumulated earnings and profits, and 50 per cent of borrowed capital, less corporate distributions previously made to stockholders. The invested capital concept involved certain adjustments, with corresponding adjustment of income. Since 50 per cent of borrowed capital is not included, half of the interest paid on borrowed capital must be disallowed as an expense deduction. Certain other assets were inadmissible, including investments in the stocks of other companies and in tax-exempt bonds, hence the income from these sources was excluded. Taxpayers were permitted, however, to waive the tax exemption on bond interest and in this case they were not required to exclude the bonds from invested capital.

There was much discussion during the formative days of the excess profits tax relative to an allowance out of income for post-war and reconversion reserves. The idea was that the excess profits tax should not apply to these reserves. The difficulty of determining the proper amount, and of distinguishing between the cases in which it would or would not be needed, and other points of administration led to the rejection of the reserve. Instead, it was provided that any portion of the standard excess profits credit that was not used in one year might be carried back as an offset against excess profits income of the two preceding years, and if any part of the unused credit still remained, this remnant might be carried forward against excess profits income of each of the two succeeding years. As an illustration, if the standard excess profits credit of a company were \$1,000,000, and if, in 1944, it earned only \$500,000, it would have an unused excess profits credit of \$500,000 for that year. Supposing that it had paid excess profits tax in 1943 on an excess profit of \$500,000, the carry-back of the unused credit from 1944 would mean that no excess profits tax would be due for 1943.

The excess profits tax rate in 1945 was 95 per cent, subject to the limitation that the total of profits tax and ordinary corporation income tax should not exceed 80 per cent of net income. Provision was made, also, for a refund of 10 per cent of the profits tax by issuing to the corporation bonds in the proper amount to be payable at specified periods after the end of the war. The act of 1945 advanced the date for redemption of

these bonds to January 1, 1946. Thus the severity of the high tax rate was mitigated, and roundabout provision was made for reconversion reserves.

Table XLI presents a summary view of the salient features in the excess profits tax returns.

TABLE XLI

TAXABLE RETURNS, EXCESS PROFITS NET INCOME, AND EXCESS PROFITS TAX, 1943 *

	Returns using		
	<i>Invested Capital</i> 44,351	<i>Average Income</i> 23,715	<i>Total</i> 68,066
Number of taxable returns	(BILLIONS OF DOLLARS)		
Excess profits net income	\$10.1	\$12.0	\$22.1
Excess profits credit	2.7	4.1	6.8
Adjusted excess profits net income	6.7	7.7	14.4
Excess profits tax before certain credits	5.7	6.6	12.3
Credit for debt retirement	.2	.1	.3
Net post-war refund	.4	.5	.9
Excess profits tax, net	5.1	5.9	11.0

* Source. *Treasury Bulletin*, September, 1945.

In 1943 there were 8,756 returns reporting an unused excess profits credit carry-over, the total of which was \$500 million. Corporations subject to the 80 per cent overall tax limitation numbered 7,670, or 11 per cent of all returns.

In some circles there have been suggestions that a tax on excess profits would be a proper feature of the federal tax system under normal peace conditions. Fortunately, such a view has very limited acceptance. The Committee on Postwar Tax Policy stated its opposition as follows: ²⁰

The principal reason for opposing an excess profits tax during peacetime is that such a tax would interfere with the function of profits, which in normal times is that of stimulating the flow of investment, guiding the direction of that flow, and inducing reduction of costs. Where there is freedom to invest and compete, the best remedy for high profit is high profit. If the immediate profit return in a particular field is high, it may indicate relatively greater risks than in other fields or that business in this field has been especially prosperous. The high return induces either further investment or that exploration of the risk which is necessary for its correct understanding and its ultimate reduction.

STATE TAXES ON ORDINARY BUSINESS NET INCOME

With the exception of New York, the states have confined their taxation of ordinary business net income to that earned by corporations. As of 1942, 32 states were taxing corporations on a net income base. In 22

²⁰ *Op. cit.*, p. 130.

states the tax was described as a net income tax, and in 10 states it was imposed as a franchise, excise, or license tax measured by net income. Seven states used graduated rates, the steepest of which was in Mississippi, where all taxable net income in excess of \$10,000 was taxed at 8 per cent. The flat rates ranged from 2 per cent in six states to 8 per cent, the highest rate, in Oregon. The exemption of intangible property, or of all personal property, or the indifferent assessment of such property if legally taxable, tend to diminish the severity of high rates.

The two most important aspects of state taxes based on business net income are the determination of net income and the allocation of net income to the state. Considerable diversity is found in the handling of both of these problems, with the result that there is some duplication and overlap. That is, the sum of the fractional parts of a given corporation net income, as it is allocated to the several states in which it does business by the methods used, may exceed the total net income. Discrimination of this sort could be removed by general observance of reasonably uniform methods of determining and allocating net income. The National Tax Association has taken the lead in emphasizing the desirability of a uniform policy, both in its model plan and in the reports of other committees.

The determination of net income. In the determination of net income, greater uniformity prevails in the deductions permitted from gross income than in the determination of the items entering into taxable gross income.²¹ Perhaps the most unfortunate aspect of this situation is the burden imposed on the taxpayers in being obliged to prepare as many different versions of their gross income and of the deductions therefrom as there are states using this kind of tax in which they are doing business. Such irregularities are expensive and annoying for the companies involved, but they are less serious, so far as the burden of the tax is concerned, than are the variations in the method of allocating net income among the states.

The distinction between taxing the net income directly and taxing the franchise or the privilege of doing business, using the net income as a measure of the tax, has given rise to important practical and legal questions. If the tax is not laid directly on the income but on a different and distinguishable object, such as the privilege of doing business, the question arises whether or not it is possible to include in gross income, and therefore in net income, items that would be non-taxable if the income were directly the object of the tax. Specifically, the question involves the inclusion of income from tax-exempt sources, such as United States bonds. The argument is that a tax on the privilege is not a tax on any specific part of the income, and that such a tax may be measured by the entire net income regardless of the elements that compose it.

²¹ For details, cf. Tax Research Foundation, *Tax Systems of the World*, 9th ed., 1942, p. 144, Table B.

The general principle that objects exempt in themselves may be included as part of the measure of a tax which is levied on some other object, itself properly taxable, has long been established. The New York capital stock tax of 1880 was sustained, even where the valuation included United States bonds.²² The federal corporation excise tax of 1909, based on the entire net income, including interest from state and municipal bonds, was also sustained, although the federal government then had no constitutional authority to tax income directly. It was held to be a tax on the privilege, and not on the income. In 1924 New York required corporations subject to the tax on the privilege of doing business in the state to report the entire net income, which included in some cases interest on federal, state and local bonds.²³ Massachusetts sought to follow the example of New York, on the advice of a legislative committee. When a test case came before the United States Supreme Court, the form of the law was rejected and the court held that the legislative intent was to tax the interest from tax-exempt securities. Hence the act was unconstitutional.²⁴ Since this decision there have been others that have had the effect, in part, of eliminating the MacAllen case as a precedent. New York was upheld in the inclusion of copyright royalties, on the ground that there was no evidence to show that the legislature had deliberately plotted to tax such income.²⁵ Georgia was also upheld in the inclusion of copyright royalties in gross receipts.²⁶ These cases do not wholly clarify the situation, since the Supreme Court had simply concluded that patents and copyrights were not federal instrumentalities.

The practical issue involved is far more important in the taxation of banks than in the taxation of ordinary business corporations, since the latter do not usually carry large amounts of tax-exempt securities. While Congress has definitely authorized the use of a franchise tax on national banks, measured by the entire net income, there may still be some doubt as to the court's view of the effect of such a tax, as there is on the general question. There is probably greater weight of precedent and opinion on the side of recognizing that the presence of income otherwise tax-exempt in the volume of income used as the measure of a tax deliberately imposed on another object is not objectionable, than otherwise.

The allocation of net income. The essential problem involved in allocation is the apportionment of the entire business net income among the states entitled to levy a tax upon or with respect to it. If all states used the same method of apportionment, all business net income would be taxed once, and only once. Uniformity of procedure is more desirable than the particular formula used, since any rule has its limitations when

²² *Home Insurance Co. vs. State of New York*, 134 U. S. 594.

²³ On the authority of *Flint vs. Stone-Tracy Co.*, 220 U. S. 107.

²⁴ *MacAllen Co. vs. Commonwealth of Massachusetts*, 279 U. S. 620.

²⁵ *Educational Films Corporation of America vs. Ward*, 282 U. S. 379.

²⁶ *Fox Films Corporation vs. Doyal*, 296 U. S. 23.

applied to all kinds of business. There would be a rough equalization, however, for the rule that gave one state an advantage in allocating the net income of certain types of business would be disadvantageous as applied to other types, but a similar result would obtain elsewhere.

There are, in general, three ways of apportioning business net income among the states. These are (1) by statutory formula; (2) by administrative determination, either as discretionary power to vary the results of a formula or as authority to allocate without reference to a prescribed general rule, and (3) separate accounting.²⁷

The statutory formula is the most common method, but the tax commission should always have discretion to modify its results in particular cases notwithstanding that the exercise of this discretion may increase litigation. The two factors most consistently used in the formulae now in operation are the tangible property and the gross receipts, within and without the state respectively. A third factor, more widely used than any other in connection with the first two, is the relative amount of wages, salaries, commissions and other personal service compensation within and without the state. These three, weighted equally, constitute what is known as the Massachusetts rule, from having originated in that state.²⁸ As applied to domestic corporations it may be expressed as follows:

1. *Income allocable by entirety*

In entirety to Massachusetts	In entirety outside Massachusetts
All interest and dividends	Gains from sale of tangible capital
Gains from sale of intangible capital	assets situated outside Massachusetts
assets and from sale of tangible property situated in Massachusetts	

2. *Remainder of net income*

$$(a) \frac{\text{Value of tangible property in Massachusetts}}{\text{Value of all tangible property}} \times \frac{1}{3} \text{ of remainder}$$

$$(b) \frac{\text{Wages, salaries, other compensation to employees, assignable to Massachusetts}}{\text{Total wages, salaries, other compensation to employees}} \times \frac{1}{3} \text{ of remainder}$$

$$(c) \frac{\text{Gross receipts assignable to Massachusetts}}{\text{Total gross receipts}} \times \frac{1}{3} \text{ of remainder}$$

$$(a) + (b) + (c) = \text{portion of remainder allocable to Massachusetts.}$$

If only two proportions are applicable, substitute $\frac{1}{2}$ for $\frac{1}{3}$. If only one proportion is applicable, substitute 1 for $\frac{1}{3}$. A proportion is inapplicable only when both numerator and denominator are zero.

²⁷ For a study of the whole problem of allocation, cf. R. S. Ford, *The Allocation of Corporate Income for the Purpose of State Taxation*, 1933. Special Report to the Tax Commission, No. 6.

²⁸ A committee of the National Tax Association recommended in 1933 general adoption of the Massachusetts rule, not only because of its inherent reasonableness, but also because of acceptance by other states, thus providing a good beginning of reciprocity. Cf. *Proceedings of the National Tax Association*, 1933, pp. 262-267.

This rule was used in 1942 by Alabama, California, Connecticut, Idaho, Louisiana, Minnesota, Mississippi, Montana, Oregon, Pennsylvania, and Utah. In 12 states, the second member of the formula, (*b*), is somewhat broader. It is "manufacturing costs," which is usually defined to include costs of material and overhead costs as well as the labor costs.

Separate accounting by states, for the business done in each state, appeals to the courts as reasonable, but its extent is necessarily limited, since only a few large concerns organize their business activities closely enough on state lines to warrant the keeping of accounts by states. Where used, the results would not be beyond challenge, for there must be, even in such cases, an arbitrary distribution of general office expenses, interest on debt, and some other items.

THE TAXATION OF AIRLINES

The growth of commercial air transport of passengers and goods naturally and necessarily led to procedures for their taxation. In the states which tax tangible personal property, the planes and other equipment would become taxable along with other classes of such property. In essence the case would appear to be parallel to that of the private car lines, such as the Pullman Company, and the numerous companies which own tank cars, refrigerator cars, and other types of specialized rolling stock. The treatment of this transportation equipment, which moves continuously over railway lines from one state to another, has been reasonably well worked out. Each state allocates to itself a proportion of the total value, usually on the basis of the car mileage within the state to the entire car mileage covered. These data are a matter of record. The principal point of discussion with assessing officers is the value to be set on the property thus assigned to a given state.

Airline operations are similar, in that they involve the movement of airplanes over established routes, with regular stops for refueling and the handling of traffic. The simplest approach to their taxation, as property, would be an allocation of the personal property values according to relative mileages flown, along the regular routes, over the several states. In the event that a particular line made no scheduled stops in a state but regularly passed over that state in its flights, there would be some room for argument as to the grounds for making any allocation. In any case, however, this allocation becomes feasible with respect to the states in which stops are made. It has been introduced, in fact, by ten states. It is the logical line of development elsewhere.

The situation was thrown into a state of confusion by the decision of the Supreme Court in the Northwest Airlines case.²⁹ The company is a Minnesota corporation, operating between Chicago and the west coast.

²⁹ *Northwest Airlines vs. Minnesota*, 322 U. S. 292 (1944).

Its home office and principal repair base are in that state, which accounted for 14 per cent of the route mileage. In 1939 the county assessor of Ramsay County made an assessment of the value of the entire fleet. The action was sustained both in the state courts and in the Supreme Court, in each by a badly divided bench. The unwisdom of the decision is apparent. The following characterization must serve, instead of a more complete discussion:³⁰

The fact that many of the states have adopted the allocation techniques explicitly sanctioned by these car-line company decisions and implicitly sanctioned by a host of decisions involving railroad taxes is completely ignored by the majority opinion in *Northwest Airlines v. Minnesota*. Indeed, Mr. Justice Frankfurter displays an almost inexcusable ignorance of property tax institutions by stating that "the doctrine of apportionment has neither in theory nor in practice been applied to tax units of interstate commerce visiting for fractional periods of the taxing year."

The worst and most disastrous outcome of this decision may be that there will be a demand upon Congress to intervene and prescribe, for the states, the methods to be used in taxing this particular method of engaging in interstate commerce. The experience with bank taxation should be a sufficient warning against such a course.

THE TAXATION OF BANKS

This account of the principal methods of business taxation will be concluded with a brief resumé of the taxation of banks. The subject has had a peculiar history and development on account of the fact that both the federal government and the states have chartered banks. The terms of the federal law relative to state taxation of national banks have therefore largely governed the tax policy of the states with respect to all banks.

The general property tax was used as the principal, but not the sole means of taxing banks prior to the Civil War. Variation from this method by the introduction of special taxes began early in the nineteenth century. The first taxes were levied either on the capital stock or on dividends and during the War of 1812 the federal government imposed stamp duties on notes issued or discounted by banks. The rates levied on capital stock were fixed by statute in some cases, but in many of the general property tax states the stock was taken to represent the personal property and was taxed locally at the property tax rates.

The federal legislation by which the national banking system was introduced contained authorization for state taxation of national banks, but imposed certain restrictions upon the manner and the extent of those

³⁰ Ronald B. Welch, Bureau of Internal Revenue, "The Northwest Airlines Case," in *Proceedings of the National Tax Association*, 1944, pp. 285-291, at p. 288.

taxes.³¹ The whole system of bank taxation since that time has developed within these restrictions. In the first place it was specifically provided that the real estate belonging to national banks could be taxed locally in the same manner as other real estate. Secondly, states were authorized to tax the shares of national banks as personal property of the holders, subject to two limitations, namely, that the tax imposed must not be at a higher rate than that imposed on other moneyed capital, and that the shares belonging to non-resident owners must be taxed only at the place where the bank is located.

The result of the restrictions imposed by the federal statutes was that each state developed a uniform method of taxing all banks within its jurisdiction. The earlier construction of the expression *moneyed capital* confined it practically to the stock of other commercial banks and probably also to that of trust companies, and to money that was used by individuals in a manner similar to the employment of bank capital. The method of taxation was uniformly that of treating bank shares as personal property of the holders. But the application of this method in different states left wide room for inequalities and divergencies, which arose chiefly from the varying standards of administration throughout the country. Great diversity occurred, both in the methods of valuing bank stocks for assessment and in the tax rates applied.

The bank tax situation was thrown into turmoil by an unexpected decision of the United States Supreme Court in 1921, in which it was held that moneyed capital meant any interest-bearing investment made by an individual.³² This decision jeopardized the classified property taxes in Minnesota, Virginia and other states, and the personal income taxes in some other states. Various national banks brought suit for recovery of taxes, and the situation threatened the revenues of a number of states. The federal law was amended in 1923 and again in 1926, with a view to providing alternative methods of taxing national banks. As a result of these changes the bank tax section of the United States Revised Statutes reads in part as follows:

Section 5219. The legislature of each state may determine and direct, subject to the provisions of this section, the manner and place of taxing all the shares of national banking associations located within its limits. The several states may (1) tax said shares, or (2) include dividends derived therefrom in the taxable income of an owner or holder thereof, or (3) tax such associations on their net income, or (4) according to or measured by their net income, provided the following conditions are complied with:

1. (a) The imposition by any state of any one of the above four forms

³¹ Cf. F. R. Fairchild, "State and Local Taxation of Banks," *American Economic Review*, Vol VI, p. 851 (December, 1916). Also H. L. Lutz, "The Evolution of Section 5219, U. S. Revised Statutes," *Bulletin of the National Tax Association*, Vol. XIII, p. 205 (April, 1928). Also Ronald B. Welch, *State and Local Taxation of Banks in the United States*, 1934, Special Report to the Tax Commission, No. 7.

³² *Merchants National Bank of Richmond vs. City of Richmond* (256 U. S. 635).

of taxation shall be in lieu of the others, except as hereinafter provided in subdivision (e) of this clause.

(b) In the case of a tax on said shares the tax imposed shall not be at a greater rate than is assessed upon other moneyed capital in the hands of individual citizens of such state coming into competition with the business of national banks; *provided*, that bonds, notes, or other evidences of indebtedness in the hands of individual citizens not employed or engaged in the banking or investment business and representing merely personal investments not made in competition with such business, shall not be deemed moneyed capital within the meaning of this section.

(c) In case of a tax on or according to or measured by the net income of an association, the taxing state may, except in case of a tax on net income, include the entire net income received from all sources, but the rate shall not be higher than the rate assessed upon other financial corporations nor higher than the highest of the rates assessed by the taxing state upon mercantile, manufacturing, and business corporations doing business within its limits; *provided, however*, that a state which imposes a tax on or according to or measured by the net income of, or a franchise or excise tax on, financial, mercantile, manufacturing, and business corporations organized under its own laws or laws of other states and also imposes a tax upon the income of individuals, may include in such individual income dividends from national banking associations located within the state on condition that it also includes dividends from domestic corporations and may likewise include dividends from national banking associations located without the state on condition that it also includes dividends from foreign corporations, but at no higher rate than is imposed on dividends from such other corporations.

(d) In case the dividends derived from the said shares are taxed, the tax shall not be at a greater rate than is assessed upon the net income from other moneyed capital.

2. The shares of any national banking association owned by non-residents of any state, shall be taxed by the taxing district or by the state where the association is located and not elsewhere; and such association shall make return of such shares and pay the tax thereon as agent of such nonresident shareholders.

3. Nothing herein shall be construed to exempt the real property of associations from taxation in any state or in any subdivision thereof, to the same extent, according to its value, as other real property is taxed.

4. The provisions of section 5219 of the Revised Statutes of the United States as heretofore in force shall not prevent the legalizing, ratifying, or confirming by the states of any tax heretofore paid, levied, or assessed upon the shares of national banks, or the collecting thereof, to the extent that such tax would be valid under said section.

This revision gives the appearance of great flexibility of bank taxation, for it provides four methods and authorizes a choice among them, instead of establishing one method arbitrarily. Unfortunately, the flexibility is more apparent than real. One alternative is the original share tax method, available, as before, to such states as are willing to attempt the taxation of all intangibles at substantial rates, or as are willing to reduce the tax on bank shares to the levels established for other intangibles under a classified property tax.

Another alternative is to include bank dividends in the taxable income of the shareholders, but resort to this method requires enactment of a personal income tax. Only about one half of the states now have such a tax and in some of the others, constitutional and other difficulties bar the way to its adoption. Since this method may, in fact, be combined with another under certain conditions, no state would be so unwise as to adopt it as the sole method of bank taxation. Indeed, it was disingenuous to offer it as a separate method in view of the conditions set out in paragraph 1 (c). Twenty-one of the states are taxing dividends paid by state banks under personal income tax laws, but all of these are taxing national banks on the share basis, which precludes taxation of national bank dividends.

The third and fourth alternatives appear to be similar but in reality they are materially different. If the tax is levied directly on the net income, the bank is entitled to determine net income according to established income tax procedure, which means, among other things, deduction of the income from tax-exempt investments. On the other hand, it is expressly provided, in connection with a tax levied "according to or measured by net income," that the entire net income from all sources may be used as the basis or measure of the tax. It is implied that use of this option involves or presupposes levy of a similar franchise tax on business corporations, in order to provide a maximum limit to the rate and thus to provide parity of franchise taxation between the banks and general business corporations. Massachusetts undertook a different construction of this condition, to the effect that the bank tax rate should not be higher than a rate equivalent to the burden of state taxes imposed on business corporations under other laws. It was not contested, and Massachusetts has now imposed a rate of 6 per cent on banks, presumably on the ground that the method of computation formerly used would always result in an equivalent rate at least as high as 6 per cent. California has also adopted a similar procedure.³³

A continuous controversy has been waged between the states and the bankers' organization. The main objective of the states has been to secure still greater freedom to devise methods of bank taxation, subject only to the condition that national and state banks shall be treated alike. Underlying this position is the doctrine that the only effective competitors of the national banks are the state banks. The banks have resisted, thus far successfully, further modification of the law. Their contention has been that the states will proceed to over-tax all banks, state and national, once Congress has removed such checks as are now provided against such a course.

It is interesting, and somewhat revealing, to note the completeness with which the original *casus belli* has been lost sight of, although this happens so frequently in controversies generally that it should occasion

³³ Welch, *op. cit.*, pp. 54-57.

no surprise in the present instance. The court has held, in numerous cases, that individuals, by investing in bonds, notes and mortgages, were actually competing effectively with the banks. If this were true, or important, no statutory change that did not reckon with it should be satisfactory. Yet, in the revision of 1926, three of the four alternatives authorized entirely ignored the possible competition of individuals, and the resulting tax discrimination if a state should exempt intangibles or tax them less heavily than it did the banks.

The truth is that no one, least of all the bankers, has ever been at all concerned over what any state might do in the way of taxing or exempting personal investments. No one has realized better than the bankers that this alleged competition by individuals was sham, not real; but the Supreme Court, in a misguided moment, provided them with an opening which they have proceeded, with admirable thoroughness, to make the most of for trading purposes, including tax refunds and tax reductions.

The contention that the states would discriminate heavily against all banks is no doubt fanciful. National as well as state banks are owned and supported locally in as great degree as are other kinds of business, and there is no convincing evidence to show that the states would single the banks out for conspicuously discriminatory treatment. Assuming that the states had such intention, no one can now say when it had been successfully accomplished. Some careful, unbiased research is needed in order to establish a reliable basis for comparison by which the existence of discriminatory bank taxes can be definitely ascertained.

In 1934 the House Committee on Banking and Currency finally reported favorably and recommended the passage of a new draft of Section 5219. It is as follows:

Section 5219. The legislature of each State may determine and direct the manner and place of taxing national banking associations located within its limits upon their real and personal property and also upon their shares; *Provided*, That in lieu of such tax upon the shares, the legislature may impose either a tax upon the net income of such association or an excise tax measured by net income received by them from all sources; *Provided further*, That such taxation shall not be at greater rates than are imposed, respectively, upon the real and personal property or shares or income of, or by way of excise (or franchise) tax upon, State banks; *And provided further*, That a State which imposes a tax on the net income of individuals or corporations may include the dividends from national banking associations located in the State, but only if dividends from the State banks of such State are similarly included; and may also tax dividends from such associations located without the state, but in such case at no higher rate than is imposed on the dividends of foreign corporations. As herein used the words "State banks" shall mean and include all persons and corporations engaged primarily in the business of commercial banking; and the word "shares" in its application to individuals engaged primarily in the business of commercial banking shall mean the capital and surplus of such business, and the word "dividends" shall in such case mean the distributed profits therefrom.

In presenting this report the chairman of the committee, Mr. Steagal, stated that its purpose was to end the intolerable conditions created in many of the states by the decision in the Richmond bank tax case.³⁴ The draft quoted above would accomplish this admirably. It eliminates the vague and indefinite reference to moneyed capital, and establishes complete parity and equality of taxation between national and state banks. It is the most promising and satisfactory attempt at revision of the federal authorization to tax national banks that has yet appeared.

The situation produced in New Jersey by the enactment of the tax on corporate net worth and the exemption of intangible personal property immediately raised a question regarding the legality of the tax on the shares of national banks. A bold and ingenious solution of the problem was proposed by The Commission on State Tax Policy in a report issued in 1946. Legislation embodying the recommendations was enacted, but time alone will reveal whether the solution offered will be acceptable. In essence the plan consisted of determining and enumerating the classes of corporations and of unincorporated enterprises which could reasonably be said to represent moneyed capital used in competition with national banks, and of transferring these classes from the net worth tax to the newly enacted bank stock tax. Thus, uniformity of taxation is to be preserved as between the banks and the entire group of financial institutions, corporate and unincorporate, which can be identified as engaging in competition with banks. The administering authority is empowered to apply the tax to any other groups which he may determine to be in substantial competition with national banks.³⁵ This is the most interesting and important development that has occurred in the bank tax mess at the state level.

³⁴ "State Taxation of National Banks," *House Report No. 1853*, 73d Congress, 2nd Session, June 1st, 1934.

³⁵ *First Report of The Commission on State Tax Policy*, Part I. Trenton, 1946.

CHAPTER XXVII

Sales and Other Taxes on Acts and Privileges

THIS CHAPTER continues with the general subject matter of the preceding one, which is the taxation of acts and privileges. In the main, the taxes to be considered here are also methods of taxing business, since the performance of an act or the exercise of a privilege of sufficient importance to warrant its being made a basis for taxation is likely to be associated with some kind of business operation. The principal privilege tax discussed in this chapter that provides exception to this statement is the motor vehicle license tax, and in this case the exception is only partial, since all vehicles used for business purposes must be licensed as well as the automobiles used for private and personal purposes.

SALES TAXES

Characteristics of sales taxes. The sales tax has appeared in various forms. In one respect a tax on the gross receipts of a public utility or an insurance company is a tax on the sales. That is, the base of the tax is the volume of sales, or of gross receipts from sales. In this form the sales tax has been used rather extensively and for a considerable time. Some of the southern license taxes belong in this general category, but their fiscal importance has not been great.

Taxes based on the volume of sales of general merchandise by retailers, wholesalers or manufacturers, or on the sales of both commodities and services, are of rather recent development in the United States. There was some agitation for this method of taxation by the federal government shortly after the first World War, but Congress did nothing toward a federal sales tax.¹ West Virginia introduced the first state tax of this character in 1921. More than thirty states have used some form of sales tax at one time or another. In 1942 twenty-three states reported receipts from this source. Two cities, New York and New Orleans, are collecting sales tax for local use. The spread of this form of taxation was accelerated by the collapse of other methods of obtaining revenue during the depression, and by the encroachment of the federal government upon certain

¹ Cf. M. D. Rothschild, "The Gross Sales or Turnover Tax," in *Proceedings of the National Tax Association*, 1920, pp. 180-209.

fields of direct taxation that otherwise might have been more fully available for state use.²

The sales taxes now in effect are of different types.³ The most clearly defined of these is the retail sales tax, which is levied upon the sale of tangible personal property at retail. The tax may apply, also, to sales made by wholesalers and manufacturers. Or it may be still broader in scope and apply to the sales of services by public utilities and to admissions, in addition to sales of tangible property. Indiana and New Mexico tax the gross receipts from personal or professional services as well as the sales of merchandise.

From the standpoint of the theory of the legal nature of the tax, the laws fall into two groups. In one group are those that impose the tax on the privilege of selling, and in the other are those that impose it simply on the act of sale. Both of these designations are to some degree misnomers, particularly in the case of the taxes on retail sales. Although in form they are taxes on the privilege or act of selling, virtually every law in this category contains provisions which require that the tax be collected from the consumer, or at least, which forbid the dealer from advertising that he has absorbed it. Thus the retailer becomes simply an agent of the state for the collection of the tax. He may assume its burden by making a price adjustment equivalent to absorption, but he would be required nevertheless to conform to the mechanics of tax collection by quoting a price and adding thereto the tax. For example, on an article ordinarily sold for twenty-five cents, on which the tax would be, say, one cent, there would be nothing in any law to prevent a merchant from pricing it at twenty-four cents and collecting one cent tax, instead of retaining the old price and adding the tax.

The rate of sales tax is proportional, and in the case of the retail sales tax it ranges from 1 to 3 per cent. Those tax laws which apply to wholesalers, manufacturers and public utilities as well as retailers provide some differentiation of rates among these classes, but the rate for each class is uniform.

Administration of these laws is vested in the state tax department except in a few cases. The administrator is the state board of equalization in California and Wyoming, and the state auditor in Missouri. Returns may be required for each month, with payment of the tax as shown, or for each quarter, or for each year. A summary annual return is required

² R. M. Haig, and C. Shoup, in their massive study, *The Sales Tax in the American States* (1934) do not find any influence or motive of general application in the introduction of sales taxes. Their rejection of all plausible motives gives it somewhat the appearance of spontaneous development.

³ Cf. the digest of state sales tax laws in *Hearings before the Ways and Means Committee on Revenue Revision of 1942*, pp. 388 ff. Also, *Considerations Respecting a Federal Sales Tax*, by the Division of Tax Research, Treasury Department, 1943. Also, R. G., and G. C. Blakey, *Sales Taxes and Other Excises*, Chicago, 1945.

in six states in addition to monthly or quarterly returns. Ohio requires a semi-annual return, but the unique system of sales tax collection in that state involves no examination of dealers' records. Vendors subject to the tax purchase and keep on hand at all times a supply of tax receipts in suitable denominations for their business. At every sale the proper amount of tax receipts is delivered to the consumer, after being mutilated by tearing or cutting.

The retailers are obliged, by law, to act as tax collectors. A considerable burden of expense is involved, which, presumably, is passed along to consumers together with other operating and similar costs. Eight states allow a percentage of collections toward reimbursement of these costs, ranging from 2 per cent to 5 per cent. Ohio sells the sales tax receipts to dealers at a discount of 3 per cent. In order to encourage purchasers to demand their tax receipts, charitable and similar organizations are allowed 3 per cent on cancelled stamps presented in amounts representing taxes of \$100 or more.

There was some tendency to exempt certain minimum amounts of gross sales receipts under the earlier laws, to avoid supervision of small retail operators, but this tendency has been reversed in the later enactments and amendments. All states exempt casual sales, sales in interstate commerce, and those made to the federal government. California and Ohio exempt food except that sold in restaurants. Farm products sold directly to the consumer are exempted in a few states, while sales of livestock, fertilizer, feed, and seeds to farmers are generally exempted. The difficulties of administration, together with the revenue need, have led the states in general to avoid extensive exemptions.

Fiscal results of the sales tax. The sales tax has become an important source of revenue in the states which have accepted it. The total yield rose from \$442,324,000 in 1939 to \$670,542,000 in 1943. The conditions of the war years produced conflicting tendencies. The inflation of incomes and prices tended toward larger sales tax receipts, while the rationing and the shortages of goods tended in the opposite direction. Evidently the inflationary forces were the stronger, for the sales tax receipts continued to mount.

The relative importance of the sales tax and the individual income tax may be tested by noting the yield of each tax in those states which impose both of them. This is done, for the year 1943, in Table XLII.

The superiority of the sales tax over the individual income tax as a revenue producer is clearly demonstrated by the data in Table XLII. The states have been hampered, of course, in their use of the income tax by the heavy rates of the federal tax, and in some of them this tax would be insignificant even without this barrier. The above comparison provides an impressive demonstration of the fact that government need not collapse or resort to deficit financing merely because the income tax is

incapable of producing what may be required. The ability of the citizens to support their government is not measured, in any of the states shown in the preceding table, solely by the yield of the income tax. Nor is there any evidence to indicate that the people who are paying sales taxes are unduly oppressed or burdened thereby. In more than one instance, proposals to repeal the tax have been defeated in referendum votes.

TABLE XLII

TOTAL TAXES, SALES TAX, AND INDIVIDUAL INCOME TAX, IN CERTAIN STATES, 1943 *
(THOUSANDS OF DOLLARS)

<i>State</i>	<i>Total Taxes †</i>	<i>Sales Tax</i>	<i>Individual Income Tax</i>	<i>Percentage Sales Tax to Total</i>	<i>Percentage Individual Income Tax to Total</i>
Alabama	\$ 61,280	\$ 13,427	\$ 2,853	21.91	4.66
Arizona	24,118	6,411	2,880 ‡	26.58	11.94
Arkansas	42,099	9,193	1,476	21.84	3.51
California	355,483	135,596	39,351	38.14	11.07
Colorado	40,931	11,727	4,087	28.65	9.99
Iowa	66,211	20,636	6,771	31.16	10.23
Kansas	48,391	14,554	4,237	30.08	8.76
Louisiana	86,289	6,063	4,349	7.03	5.04
Mississippi	45,293	13,164	3,465	29.06	7.65
Missouri	84,770	31,168	9,941 ‡	36.77	11.73
New Mexico	18,672	5,895	494	31.57	2.65
North Carolina	103,516	17,536	8,647	16.94	8.35
North Dakota	18,526	4,314	1,084	23.29	5.85
Oklahoma	71,953	16,339	4,524	22.71	6.29
South Dakota	15,169	4,176	557	27.53	3.67
Utah	22,191	6,698	2,051	30.18	9.24
West Virginia	53,686	33,277	775	61.98	1.44
Totals	\$1,158,578	\$350,194	\$97,542	30.23	8.42

* Source: Bureau of the Census, *State Finances*, 1943

† Excludes unemployment compensation taxes

‡ Includes corporation income tax

The normal disposition of sales tax revenue would be to place it in the general fund, along with all other revenue, to be expended in accordance with appropriation acts. The departures from this principle, in the case of the sales tax receipts, are for relief and welfare, or for education. In 1945 three states allotted the entire yield to the first of these purposes (Colorado, Oklahoma, and Utah), and three other states allotted the total receipts to education (New Mexico, North Carolina, West Virginia, from retail sales). Seven states divided the yield between the general fund and one or other of the above purposes, while eight states covered the entire amount into the general fund.

Some problems of sales taxation. On the surface it would appear that the taxation of sales is a fairly simple matter. The merchandising process goes on so smoothly, or so it seems to those not directly involved in it, as to present an excellent opportunity for the imposition of a tax without encountering the administrative difficulties that have caused so much trouble in the case of other taxes.

But these appearances are deceptive. As a matter of fact, sales tax administration offers some serious problems. The subject is too technical and too involved to be dealt with here in any fullness but certain matters of rather general interest and concern will be outlined briefly.

Definition of a sale. Ordinarily a sale is thought of as a transfer of property for a consideration, usually a sum of money. So it is, for the most part; but there are other ways of effecting the transfer that are not always so clearly to be classed as sales. These include conditional sales, leases, trusts, chattel mortgages and other similar methods which may constitute actual conveyance of personal property. If a law is designed to reach all of the cases of actual transfer, it may result in taxing the bona fide uses of lease, mortgage or other conditional and limited conveyances of the control over and use of property.

Another difficulty is presented by the time element, which appears particularly in the case of conditional, approval or installment sales. Is the article sold when the buyer agrees to take it or when a down payment is made, or when it is fully paid for, with no further opportunity of returning it and claiming a refund?

Still another aspect of this problem is presented by the matter of resale. The intent, in a retail sales tax, is to tax the final transfer to the consumer. But the final consumer of such things as fuel and machinery is the manufacturer. One procedure would be to classify such sales as wholesale, and thus to exempt them. Some states have provided a specific exemption of these and similar goods. In other states the physical-ingredient or component-part rule has been developed, according to which the sale of a commodity which is to emerge as part of the final consumption product is exempted. Since fuel, lubricating oil, machinery, and other factory supplies and equipment do not constitute physical ingredients of the finished product, such sales would be taxable under a strict application of the rule. Obviously, it is improper to include sales of material or equipment used in production within the scope of a retail sales tax. The same logic would exclude sales of machinery and farm supplies to farmers. Yet the maintenance of a clear distinction in all cases has presented difficulties.

These cases will serve to illustrate the complexities of sales tax administration. The regulations issued by the several administrative authorities elaborate at length on such matters, and they should be consulted by those interested in further details.

Interstate commerce. Under the existing judicial construction of the commerce clause, the states may not directly burden interstate commerce by any tax or regulation. It therefore becomes important to determine what sales are made in interstate commerce. So far as concerns the state in which the seller is located, any transfer that involves an interstate shipment is likely to be regarded as interstate and hence not taxable. The state into which the goods come has difficulty in taxing them as long as they remain in the original package. Once this is broken, the goods are deemed to have become part of the general mass of property and any subsequent transfer by a dealer or agent is taxable. Shipments from a mail order house to the consumer in another state would seem to be exempt in both states. An attempt has been made to meet the interstate commerce difficulty by means of a use tax. This adjunct of the sales tax is dealt with later.

The collection of small tax items. The limitations of the fractional currency system give rise to a problem of adjustment under the low rate retail sales taxes. When the rate of tax, applied to the particular small sale, does not result in a tax expressible in even cents, the dealer's only option is to collect another penny. Often the correct tax is less than one cent. In effect this makes the tax regressive on such transactions, and it may result in some profit to the dealer out of the tax, for his settlement with the state requires payment of the tax on the entire volume of sales at the fixed rate. He is not obliged to account for all of the odd pennies collected.

Two methods of eliminating this source of annoyance and friction have been devised. One is a series of brackets, indicating the price ranges below \$1.00 in which one, two or three cents will be collected, as the case may be. This device does not altogether eliminate the regression or the chance of profit for the dealer. The other is the use of tokens whereby the exact amount of the tax, in fractions of a cent, may be paid.

The use tax. The use tax is a device that has developed since 1935 to counteract the limiting effects of the interstate commerce clause. In form, it is a levy on the use, storage, or consumption of tangible personal property that would be subject to the sales tax if bought within the state. In some states the use tax is applicable, legally, to all tangible personal property held for use, storage, or consumption, with an exemption of such property as had been subjected to the sales tax. It is obviously aimed at the practice of buying goods in another state, either through mail orders or by shopping across the state line. The rate of tax is naturally the same as that of the sales tax itself.⁴

The use tax is impossible of effective administration, and so far as the rank and file of citizens are concerned, it is observed in about the same way as was the general property tax on intangible property. That is, the ordinary person ignores it, and the only taxpayers are certain business

⁴ Cf. Blakey, *op. cit.*, pp. 21, 22.

houses which do their merchandising across state lines. A liberal exemption is usually allowed which simplifies the situation for the administrator and stultifies the tax for the average person.

The courts have sustained use taxes, even to the extent of permitting a state to compel a seller in another state to collect and transmit the tax on goods consigned to purchasers in the taxing state. The line of judicial reasoning has been that no discriminatory burden on interstate commerce is involved. Granting that such may be the case, the dangers inherent in this sort of extension of state jurisdiction to persons and business operations beyond its borders are such as to raise considerable doubt as to the long-range wisdom of the procedure.

The collections under the use tax are not segregated and reported by all of the states which impose it. In Table XLIII the latest available data on this subject are presented.

TABLE XLIII
SALES AND USE TAX COLLECTIONS IN CERTAIN STATES, 1943
(THOUSANDS OF DOLLARS)

<i>State</i>	<i>Total Sales and Use Tax</i>	<i>Use Tax</i>	<i>Percentage, Use Tax to Total</i>
Alabama	\$ 14,867	\$1,161	7.9
Colorado	11,727	365	3.1
Iowa	20,636	1,114	5.4
Kansas	14,554	498	3.4
Michigan	86,408	2,315	2.6
Mississippi	13,164	151	1.1
North Dakota	4,314	161	3.7
Ohio	62,980	1,098	1.7
Oklahoma	16,027	798	4.9
Washington	39,160	1,678	4.3
Totals	\$283,837	\$9,339	3.3

The place of the sales tax in the revenue system. In the states that now use the sales tax, the question of its place in the revenue system is academic. In 1943 sales tax receipts were the second largest among all the state tax receipts, although the tax was then levied in only twenty-three states. Even so, the sales and similar taxes accounted for 17 per cent of all state tax revenues, excluding the unemployment compensation taxes. In Table XLII, on page 469, the relative contribution of the sales tax and the individual income tax in certain states is shown. For the entire group of eighteen states, the sales tax provides, on the average, 30.23 per cent of total tax revenues.

In view of these facts, the place of the sales tax in the revenue systems of the states which now levy it, appears to be secure. Such a violent re-

adjustment of the state tax structure would be involved, in any of these states, were the sales tax to be dropped, as to be unthinkable.

Notwithstanding the concrete evidence of its productivity, opinion as to the merit of the sales tax is sharply divided. The principal argument used against it is the alleged regressivity. The tendency to employ the term *regressive* improperly in connection with taxation has been noted above.⁵ That is, the amount of tax paid by any individual is stated in relation to the taxpayer's income, rather than in relation to the amount of his purchases. Almost any tax now in use, including such favorites as the gasoline tax, the property tax, the liquor and tobacco excises, are regressive in relation to income. It is curious, however, that this point is seldom, if ever, raised, in opposition to these taxes, although it frequently is in opposition to the sales tax.

On the other hand, in addition to its productivity, the sales tax, like the excises on particular commodities, is likely to be more resistant to business decline than the taxes on net income. In so far as stability of the revenue is important in order to obviate the necessity of borrowing during depressed periods, a broad system of excises, or even a general excise or sales tax, would be a useful feature of a diversified tax system. It was for this reason that the Committee on Postwar Tax Policy emphasized the desirability of maintaining a broad federal revenue base through the use of excises, or even of a federal retail sales tax.⁶

The limitations on the income tax were discussed in an earlier chapter.⁷ As noted there, only a minor portion of the total income payments emerge as net taxable income. Under the personal exemptions and dependency credits now allowed, namely \$500 per person for normal and surtax, large numbers of persons will make no direct contribution to federal revenues. Since it is not feasible, for administrative reasons, to push the exemption limits much below the present levels, the sales tax becomes available as a method of collecting something from those who would otherwise pay no federal tax. Since those who would, in any case, pay income tax would also be subject to the sales tax, there would be no basis for contending that the low income groups were being unduly oppressed. In fact, there is no evidence that the great mass of the citizens in the sales tax states regard this tax as oppressive or inequitable. Their continued support and acceptance of it testify to this attitude.

MOTOR VEHICLE LICENSES

As soon as the automobile passed the experimental stage and began to appear generally on the highways, a system of licensing was introduced. The development of this system has gone on unevenly, and there is still

⁵ *Supra*, p. 258.

⁶ Cf. *A Tax Program for a Solvent America*, New York, 1945, Ch. 2.

⁷ *Supra*, Ch. XXI.

lacking in nearly every state the evidence of a clear philosophy on which to base the amount charged. The rates now imposed vary so greatly that no clear, concise summary of the current practices can be given. Some instances of the procedure will be presented in order to illustrate the diversity that exists, and some other data will be indicated, preliminary to a discussion of some of the problems involved in the licensing system.

Some characteristics of the motor vehicle licenses. It is necessary for several reasons that all motor vehicles display an identifying symbol when used on the highways. This has become standardized as the license plates, issued by state authority and bearing distinctive numbers or letter and number combinations. Their possession is evidence of payment of the required license. With them is issued a registration certificate carrying the owner's name and address and a description of the vehicle, with its individual serial numbers. A duplicate of the registration certificate is kept by the state authority.

Prerequisites of registration. The first and most important prerequisite is evidence of ownership, consisting of a bill of sale given by a dealer or the other, last previous seller. The states were surprisingly slow in developing this requirement, and were only prodded into doing by the growth of a flourishing traffic in stolen automobiles. Fairly strict provisions now exist for the protection of title ownership.

Another prerequisite that is found in twelve states is payment of the property tax levied on the motor vehicle, either as a preliminary to, or, in Nevada, at the time of registration. In seventeen states the license is in lieu of property taxes. Massachusetts and Maine do not tax automobiles as property, but they have devised a substitute method which amounts to the same thing. It is called an excise tax, levied in Maine on the factory price, at rates which diminish from twenty-three mills in the first year of the model to three mills in the sixth and succeeding years. Massachusetts levies the average state rate of taxation on a valuation which starts with the factory price and is depreciated each year according to resale experience. California and Colorado also levy a special ownership tax in lieu of property tax.

A general system of reciprocity prevails with respect to non-residents, which means general freedom for the American motorist to travel over the largest highway network in the world without payment of any except his initial motor vehicle license. In some states the exempt period is limited, by law, to sixty or ninety days, but there is no effective means of checking up on the visitor except in the three cases, California, Mississippi and Oregon, in which registration, without payment of a fee, is required upon entrance into the state.

A prerequisite to operation, but not to licensing the vehicle, is the driver's license which is now required in all states except South Dakota and Wyoming, at rates ranging from twenty-five cents to \$3.00. Chauffeurs

must be licensed in twenty-six states. Unfortunately, the procedure of licensing drivers is simply a formality of taking the money in most of the licensing states.

License rates. On private passenger cars the rate may be either a low, flat sum, or an amount graduated according to horsepower, gross weight or value. Arizona, California, Idaho, Louisiana, Nevada, Oregon, Utah and Washington provide the only examples of the low, flat rates. In nine states the basis is horsepower and in twenty-three it is gross weight. Two states combine weight and horsepower and four use a flat sum plus a variable computed on the weight or the value. Iowa and Minnesota base the license on the value, an adaptation of the Massachusetts excise plan, except that the latter is not the sole charge, nor is it the basis of the vehicle license. The licenses for private automobiles may range, therefore, from \$3.00 in California or Washington to as much as \$50 in Minnesota.

The licenses for trucks are more uniformly based on the gross weight of vehicle and load. Despite a fairly general tendency to graduate the rates according to weight, there is extreme variation in the amounts charged for the heavier vehicles. In California the maximum fee is \$73, payable on gross weight of 26,000 pounds or over; and in New Jersey the highest rate is \$99, on gross weight of 30,000 pounds. At the other extreme is Georgia, where a truck with more than ten tons capacity pays \$1,000 annually.

The licenses for trailers and tractors conform in general to the relative scales for trucks, and in a number of states the rates are the same. In the case of busses, the regular truck rates may apply, or in a few states the passenger car rates apply. Additional taxes are usually levied according to the number of passengers seated or on the gross revenue or the mileage traveled.

The fiscal returns from motor vehicle licenses. The growth of the motor vehicle license revenues of all states since 1916, including drivers', chauffeurs' and dealers' licenses, is shown in Table XLIV.⁸

TABLE XLIV
MOTOR VEHICLE LICENSE REVENUES FOR CERTAIN YEARS SINCE 1916
(THOUSANDS OF DOLLARS)

<i>Year</i>	<i>Amount</i>
1916	\$ 25,865
1920	102,546
1924	225,492
1928	322,630
1930	355,844
1934	261,198
1940	386,626
1945	406,446

⁸ Data compiled by the federal Bureau of Public Roads, published in *Tax Systems of the World* (1935), p. 213, and by the Bureau of the Census for 1940 and 1945.

The total revenue rose rapidly from 1916 to 1924, then less rapidly but nevertheless impressively to 1930. From that time until 1934 there was a drop of more than \$94,000,000, indicating the extent to which the depression checked new car buying and the renewal of registrations. During the second World War, motor vehicle production was largely suspended, but the transportation needs kept many vehicles in service that would normally have been scrapped. The license receipts in 1945 were only slightly below the all-time record of \$415,457,000 in 1941.

Problems of motor vehicle licensing. The foregoing extremely brief summary of the licensing situation does not bring out all of the problems involved, though it directs attention to the more important ones.

Theory of charges. The issue of first importance is undoubtedly that of the proper theory on which to build a system of licensing for motor vehicles. There is no necessary or absolute principle by which to determine the proper scale of licenses. It is a matter that each state is competent to determine, although it is a subject that may give rise to conflicts or jealousies when state practices vary widely, particularly with respect to trucks and common carriers.

The one and only minimum essential is a means of identification, for police regulation and the protection of owners. If a state should decide to supply, gratis, the license plates for this purpose, or to charge only enough to cover the costs of manufacture and distribution, there can be no quarrel with the action as an expression of policy. The low flat rates in California and a few other states accomplish this essential minimum, on substantially a fee basis.

Beyond this point, all else that is charged is in the nature of taxation of a particular privilege, namely the privilege of operating a motor vehicle on the highways. In the beginning of highway construction, far back in the days of the horse and buggy and the prairie schooner, the use of roads and bridges was not always free. Tolls were charged to defray the cost of construction and upkeep. The toll gate and the toll bridge had largely gone, however, by the time the motor vehicle appeared.

Its advent brought a new era of large expenditure for the construction of a different and expensive type of highway, adapted to the needs of mechanical rather than animal power in transportation. The financial burden of this construction was so great as to compel reversion to the essential principle of the old toll system, which was that the users of the highway should contribute to the cost. In some specific cases of bridges, tunnels, and express highways, the toll itself returned; in general, new methods of taking toll were at hand in the essential characteristics of the motor vehicle. These were the gasoline tax and the license.

The total amounts collected from highway users under these taxes made possible the rapid and expensive construction that has occurred, although, as tolls, they did not cover the whole cost. Evidence of the

deficiency is found in the large amounts of state and local borrowing for roads and streets, in the heavy taxes on property for these purposes, and in the federal highway grants. To some extent there is an element of general social advantage in a good highway system, so that it was not necessary to require or to expect that the users should pay the whole cost, although it was reasonable to ask that they bear a substantial part of it.

Now that the country's highway system is developed as it is, and leaving aside the question of the merits of the distribution of burden effected in the financing methods employed thus far, the important problem of policy is that of the future. What attitude shall be taken henceforth toward the peculiar system of tolls that has been used?

The case of the gasoline tax has already been discussed. It is possible to regard this tax, either as a levy for highway purposes, or as a commodity tax that reaches as large a proportion of the population as would be reached by any other tax on commodities of general consumption.

In considering the future of the motor vehicle license, the two elements that will always be present are (1) the necessity for police regulation, and (2) the fact that use of the highways means wear and tear. In other words, there will always be a bill for highway upkeep, and there will be eventually a bill for replacement. The principal justification for a toll element in the license, over and above the fee that is charged to cover the cost of providing the license plates or tags, is in the necessity of exacting from highway users some contribution toward upkeep, and eventually toward replacement. This does not mean setting aside reserves from the license receipts for reconstruction; but it does mean relieving other taxpayers from the maintenance burden, in view of the fact that in time they must be called upon to finance reconstruction.

Whether it is consciously realized or not, a state's policy with respect to the scale of motor vehicle licenses represents its answer to the question of the degree to which the motor vehicle user shall contribute toward the maintenance of the highways. Therefore, although there is no quarrel with the policy of charging for all licenses on a fee basis, it is possible to criticise the wisdom of such a policy on the ground that it represents a serious maladjustment between the charge and the burden of cost that is involved in highway use.

It may be urged that the gasoline tax is a sufficient recognition of the differential. The heavy vehicle uses more gasoline per mile than the light one, hence there is a greater relative contribution toward the highway expense. But this is only a partial corrective. The destructiveness of highway use depends on both weight and speed. The engine power of heavy trucks and busses now enables them to travel, loaded, at speeds approximating the safety limits for cars of any size. Neither their excess gasoline consumption per mile nor their relatively larger annual consumption in

view of the mileage covered, will wholly equalize the differences in the destructiveness of impact resulting from the differences in weight.

With respect to a theory of licensing, it appears, therefore, that there is justification in charging something in the nature of a toll or tax, in order to apportion the upkeep burden more definitely in accord with an important cause of the repair bill, namely the relative destructiveness of the highway use.

Before proceeding to consider how best to accomplish this, one other aspect of the situation requires attention. This is the problem of equalizing the competitive relations of motor transport with other transportation facilities, especially the railroads. The spread of the automobile has cut into railroad passenger traffic, it is alleged, and the use of trucks has made inroads into the freight traffic that once moved by rail. Insofar as highway costs have been met by general taxation, the railroads were compelled to contribute toward the construction or maintenance of facilities that favored their competitors. The cost of grade crossing elimination in particular has fallen heavily on the railroads, although the motoring public has been the chief beneficiary. Emphasis has been laid on the advantage of a public right of way and a roadbed provided partly by general taxation as factors in reducing the costs of travel or shipment by highway.

No precise evaluation of the differential advantages enjoyed by highway users could ever be made, assuming that some approach to equalization were desirable. It is unreasonable to require the railroads to pay heavily toward the cost of grade crossing elimination, and this is being recognized to some, though perhaps as yet inadequate, degree. Moreover, it is impossible to measure with any definiteness the extent of the railroad losses due to the motor vehicle. They have lost some short-haul commuting and shopping travel, but the shortsightedness of the railroad fare policy and service accommodations has prevented effective steps to hold or to regain it. Much of the long distance touring by automobile is travel business that the railroads would not have had, even without the motor vehicle. It is new business, produced by the lure and freedom of the open road. They have both lost and gained traffic by reason of the truck, and no one has cast up the balance.

All things considered it is impossible to find a satisfactory clue to the proper scale of licenses in the indefinite and intangible materials of the competitive transportation situation. The ownership and use of motor vehicles are subsidized in various ways under the tax system in some states, owing to the curious notion that has prevailed that payments for road purposes through the gasoline tax and the license absolved the owners of this class of property from any contribution on account of such property toward general governmental costs. This subject is dealt with later. For the license, a better case can be made on the basis of

highway destructiveness than on any supposed advantage over other means of transportation.

The scale of licenses. The subject of motor vehicle licenses has been studied at some length by various committees of the National Tax Association,⁹ and the conclusion has been reached that as a measure of highway use, such factors as horsepower, net weight, value, or piston displacement, are inferior to gross weight. In order to adjust the license to the progressively destructive effect of the heavier vehicles, the following formula was suggested:

tax equals c plus $m (w^2)$.

In this formula c is a constant, and might be thought of, though the committee did not suggest this, as an approximate equivalent of the fee element, the cost of supplying the license plates and registering them. On this basis, it could be three or four dollars. w is the gross weight in tons, and m is a multiplier, such as two or three. Flexibility in the relative results may be achieved to fit the requirements of any state by varying either the constant or the multiplier. For example, if values of four and three are given to c and m , respectively, the formula would read, tax equals 4 plus 3 (w^2). For a vehicle weighing under two tons, gross weight, the license would be \$7.00, and for one with a gross weight of fifteen tons, it would be \$679. A less rapid progression would be obtained by using a smaller value for m , such as 2 or 2½, and a higher license on the average small car would be obtained by using a greater value for the constant c .

The license should be heavier for vehicles with solid tires, and it would be proper to make a percentage reduction when the weight is distributed over three axles, with six or more wheels, since the distribution of the weight in such case lessens the force of the road impact by any wheel.

Other problems of motor vehicle taxation. Payment of the special toll or privilege taxes for the use of the highway and as a contribution toward its cost and maintenance, should not be regarded as a complete and sufficient discharge of the governmental obligation with respect to this property. A reasonable application of general rules would require that property taxes or business taxes should be imposed on this, as on other property, or on any use of motor vehicles for business purposes. The National Tax Association committee quoted above says, on this point: ¹⁰

...if a property tax is levied on tangible personal property of other classes it should likewise be imposed on motor vehicles. ... Likewise, it should

⁹ Cf. the committee report and discussion in *Proceedings of the National Tax Association*, 1930, pp. 135-195.

¹⁰ *Loc. cit.*, p. 163.

be said that if an income tax is imposed on income from the employment of tangible personal property in general it should also apply to the income derived from the operation of motor vehicles.

There are three ways in which the question of general, as distinguished from special, motor vehicle taxation appears. These are under the property tax, the business tax, and the franchise tax.

Taxation of motor vehicles as property. There is every reason for agreeing with the pronouncement of the committee on this subject, as quoted above. The motor vehicle owner is a beneficiary of numerous governmental services, simply by reason of his ownership and use of such a vehicle. Fire, theft, property damage and personal injury are some of the hazards that beset him; and he must rely on various governmental agencies to protect, or to secure, his rights under any or all of these contingencies. Insurance transfers the responsibility in part, but it does not eliminate the need of governmental agencies. In view of the peculiar vulnerability of the automobile owner, with respect to these benefits and services, it is especially incongruous to exempt this class of personal property while continuing to tax other classes. The familiar argument against personal property taxation to the effect that the tax is not readily enforceable is not valid in this instance, for prepayment of the property tax can be required as a condition of issuing the license. The plan used in Maine and Massachusetts has some merit in that it provides a method for state-wide uniformity.

The taxation of business income from motor vehicles. The use of motor vehicles for regular transportation purposes, whether as common or contract carriers, gives rise to the question of applying to them any business tax upon, or measured by net income. Individuals or business concerns using motor vehicles in their own business regard whatever advantage or profit that results as part of the general income or profit of the enterprise, consequently the point could only arise with respect to the use of such vehicles as a means of profit per se. The agency doing this is a common carrier, if persons or property are transported for compensation according to definite schedules or rates, between fixed termini. If the transportation is by contract, and not available to the public generally upon payment of the scheduled fares or rates, the agency is known as a contract carrier. The states that tax business generally on the basis of net income, include the motor carriers along with other classes of business enterprise under such a tax.

A new device for promoting effective administration of special taxes on motor carriers is the port-of-entry used in Kansas. Motor carriers not licensed in the state are required and permitted to enter and leave only over designated routes. Border stations on these routes check the weight or the mileage and collect any special taxes that may be due. A similar plan is used in New Mexico.

Franchise taxes. The motor common carrier is properly in the public utility class, and a number of states require that a certificate of convenience and necessity be obtained from the utility commission before motor common carrier lines or routes may be established. This is not so true of the contract carriers, but there is a disposition to tax both the common and the contract carriers on their gross receipts. It constitutes an approach to the methods of franchise or business privilege taxation under which the other utilities are taxed.

The driver's license. The states generally have been singularly indifferent to the importance of regulating the qualifications of those who drive motor vehicles. They are ordinarily quite strict about the license for the vehicle, and police officers gladly arrest drivers who have no license plates, or who try to get along with those of the previous year. In reality, this may be a far less serious matter at the moment than the qualifications of the driver himself.

The driver's license requirement will not eliminate all traffic accidents, nor will it assure universally careful driving. It is a useful means of weeding out the worst incompetents, and through suspension or revocation, it may be a means of instilling caution in some reckless drivers. The requirement should be universal, and the license should be given only after the applicant has demonstrated his ability to drive carefully. The amount charged should be on a fee basis, and the aim should be to collect only enough to cover the costs of examining candidates and issuing the licenses.

SEVERANCE TAXES

The name *severance tax* was originated in Louisiana to describe a tax imposed on the privilege of removing, or severing, certain raw materials or natural resources from the land or water within the state's jurisdiction. Not much is known about this tax, in the sense that no one has undertaken a special study of the underlying theory, the correct relation to other taxes, particularly the property tax, or the administrative problems involved. It has certain connotations of conservation, but no one has yet shown what its actual effect in this direction may be.

If the term is to be correctly applied as defined, there are not many clear examples of its use. Various taxes on the production of natural resources are often put in this category, but examination of their character reveals that they are either fees to cover the cost of certain supervisory and inspection services, or they are a method of taxation that has been developed as a substitute for the property tax.¹¹

¹¹ This error was made in the 1935 edition of *Tax Systems of the World*, p. 140. There the Nevada tax on the net proceeds of mines is listed as a severance tax, whereas it is an adaptation of the property tax to the peculiar conditions of silver mining. The Utah tax on net proceeds is not included, though it is similar. Likewise the forest yield taxes of Oregon, Idaho and Wisconsin are called severance taxes,

With respect to forests, Professor Fairchild reached the following conclusion in the course of the exhaustive forest taxation inquiry:¹²

There is no justification for a severance tax, in addition to property or other adequate tax, in the case of forests, except possibly as a measure to be applied to forests destructively exploited without provision for restocking. Only two states, Arkansas and Louisiana, now have severance taxes in addition to the property tax upon forests.

The Minnesota tax on iron ore may properly be regarded as a severance tax. It is levied at 6 per cent on the value of the ore mined, after deducting the reasonable cost of mining, royalties, and an apportionment of the property taxes levied on all unmined ore. All known deposits of ore are assessed at 50 per cent of their true value, which is ascertained by computing the present worth. Under this procedure, the value of a ton of ore in the ground, from which it may not be taken until 1950 or 1960, is necessarily small. Once above ground, ready for shipment to the furnace, its value is definitely greater. The occupation tax, as it is called, is levied on the net increase in value due to the mining process. A companion tax on royalties, at 6 per cent, distributes the burden of the severance tax between the mine operators and the lessors.

The problem of the proper taxation of natural resources is difficult, and, aside from forests, has never been gone into thoroughly. It may be that an investigation as intensive as that which has recently been completed in the case of forests would lead to a similar conclusion regarding the usefulness of the severance tax on mining, oil, and gas production, and other branches of the extractive industries. It is probably true that a heavy annual tax, such as is imposed under the property tax, based on assessments purporting to include the entire known quantity of the resource still in the ground, is a factor tending to speed up the rate of exploitation. The accumulation of each year's taxes against the value of the resource lessens the probable profit margin when it is produced. Hence there is pressure to get it out quickly.

Under these circumstances it is not easy to see how a severance tax, levied on the privilege of extraction in addition to other taxes on the resource as property, promotes conservation. On the other hand, the substitution of a yield or production tax for the annual tax on the whole value not yet extracted, would probably have an influence toward conservation; but so many other factors enter, such as market price, operating

but they are actually in lieu of the property tax, and are applicable to only a small part of the entire forest area. The California charge on petroleum and natural gas, at rates to produce \$275,000 annually for the department of natural resources, and the Colorado levy of $\frac{3}{10}$ cents per ton of coal, for the support of the bureau of coal mine inspection, are fees rather than taxes.

¹²F. R. Fairchild, and Associates, *Forest Taxation in the United States* (1935), p. 635, United States Department of Agriculture, Miscellaneous Publication No. 218.

costs, the degree to which other areas not subject to the tax might supply the same material, and others, that definite estimates of the effect of the tax are likely to be unreliable.

CHAIN STORE TAXES

The rise of chain store systems led to attacks from various angles. In twenty or more states one aspect of this attack has been a special license tax, usually graduated according to the number of units in the chain within the state. The Colorado tax, one of the highest, rises to \$300 on each unit if the number exceeds twenty-four. In Georgia the first unit of a mail order chain is taxed at \$2,000 per year, the second unit at \$4,000, and so on, with all units above the first four taxable at \$10,000 per year.

Under the impact of these taxes, and perhaps for reasons connected with the application of the anti-trust laws, some changes have occurred in the merchandising of oil products and foods. The oil companies have largely withdrawn from the retail field in favor of independently operated stations which may or may not be financed by the company whose products are sold. In food distribution, small chain units have been consolidated into supermarkets. To some extent the advantages of a chain system, which lie principally in buying, warehousing, and some other aspects of centralized management, are thus retained at a lower penalty in taxes.

The chain store license tax is a product of the rivalry between the local, independent retailers and the chains. The former still greatly outnumber the latter, and in 1939 they sold 74.7 per cent of total retail sales. The only attempt to rationalize a chain store tax that has come to this writer's attention is the argument that the personal property tax operates unequally as between the chain and the independent because the former normally carries a much smaller stock and gets sales volume by rapid turnover. Hence it would have a relatively low assessment on the basis of average monthly inventory.

Assuming such an argument to have some basis, it would provide justification, at best, for some supplemental tax at a flat rate or amount per unit, so determined as to provide approximate equalization of the personal property burden. It would be no defense whatever for the severe progression of the rate found in most states. These rates make it plain that the real purpose is destruction, and not revenue or the equalization of tax burdens.

MISCELLANEOUS PRIVILEGE TAXES

Scattered through the laws of the forty-eight states will be found a considerable aggregate of provisions that impose charges of one sort or

another. Some of these are privilege taxes, others are fees for inspection or supervision, or licenses. A few may properly be regarded as severance taxes. As noted in the preceding chapter, the southern states have long made use of licenses on a great variety of occupations as a part of their regular revenue system.

Among the more important commodities, sale of which is subject to inspection fees, license or similar exaction, are commercial fertilizers, feedstuffs, illuminating and lubricating oils, and cement. Commercial fisheries are usually licensed and taxed at low specific rates on output. Some states license the trapping of fur-bearing animals at low rates that vary with the quality of the furs. In the aggregate these miscellaneous licenses, fees and privilege taxes constitute only a minor source of revenue. Their administration is likely to be scattered about among the state offices, with the result that much of the revenue in each case is required to support the staff of inspectors and other agents required for administration. Thus, whether it is intended or not, these charges tend to function as fees.

The steady growth of interest in horse racing, and the increase in the number of states which legalize and regulate betting has elevated this sport into the realm of big business. In 1944 the attendance at 46 race tracks totalled 18,000,000, and a total of \$1,136,000,000 was wagered through pari-mutuel machines. These are complicated machines which apportion the total amount wagered on a particular race among the holders of the winning tickets, after deducting the percentage which the operator is authorized to take out for his expenses, taxes, and profits. In 1944 the total state revenues from the betting taxes and licenses were \$57,000,000. The collections in Rhode Island and New Hampshire were 16.95 per cent, and 14.94 per cent, respectively, of total state tax revenues, excluding unemployment compensation taxes.¹³

¹³ Cf. *State Taxation of Horse Racing and Pari-Mutuel Wagering*, Project Note No. 14, issued by The Tax Foundation, 1945.

CHAPTER XXVIII

Inheritance and Estate Taxes

THE TRANSFER OF property from one generation to another occurs in two ways, by inheritance or by bequest. *Inheritance* means succession to the property by virtue of blood relationship, and *bequest* means a grant of succession by virtue of a will or testament. The transfer of property in the family line, that is, by inheritance, must be as old as the institution of private property itself. In the beginning bequest was unknown, and if relatives were lacking, the property reverted, or escheated, to the state. It is said that the Romans introduced the legal concept of bequest, to enable those who had no near relatives to make disposition of their property. Bequest has developed, therefore, as a means of sustaining the institution of private property, since it narrows the tendency of reversion to the state that would otherwise operate as the family tree becomes barren.

Two general types of death tax are used; the *inheritance* tax, which is based on the shares received by the respective heirs, and the *estate* tax, which is based on the entire estate before it is distributed to the heirs. This chapter will deal with their development and characteristics, their fiscal results, and with some of the problems encountered.

THE THEORETICAL BASIS OF DEATH TAXATION

There has been much speculation as to whether inheritance and bequest are natural rights of the heir and the decedent, respectively, or are civil rights which the state has found it expedient to allow. The latter view now generally prevails and the principal justification of the authority to impose death taxes is that the state regulates the transfer of property from one person to another at death. Technically the tax is not imposed on the property but on the privilege or act of transferring it. Some of the states have been careless in phrasing their laws and have enacted tax statutes which, in terms, impose the inheritance tax on the property. As sometimes happens in such cases, the constitution requires uniform taxation of property, and a strict interpretation would nullify progressive inheritance tax rates.¹ The courts have chosen to look beyond

¹ For example, the Maine law (*Code of 1930*, Ch. 77, § 1) provides: "All property within the jurisdiction of this state... which shall pass by will, by the intestate laws

the form to the substance of these laws and have accepted them as taxes on the transfer of property, although as written they are taxes on the property.

In the case of the federal tax, which is imposed on the transfer of the net estate, some basis other than the right to regulate transfer had to be found, for the federal government has nothing to do with either legislation or administration relating to inheritance, bequest, the recording of property titles or other matters involved in property ownership. These are all subjects of state legislation and control. The federal estate tax is therefore regarded as an excise tax, imposed on the act or privilege of transferring property at death. As an excise it is within the federal tax jurisdiction. For both federal and state governments, the value of the property transferred is used as the measure of the tax. In valuing the estate or bequest, tax-exempt securities are included in order to arrive at a proper measure of the tax, since the tax is not on the property as such.

Death taxes are now very generally imposed at graduated rates. Under the inheritance tax type, the progression is often twofold; that is, the rate scale varies with the size of the inheritance, and also with the degree of relationship between the beneficiary and the decedent. Exemptions are usually highest for members of the immediate family. In this there may be some tag-ends of an ability to pay theory, on the far-fetched assumption that the receipt of property through inheritance or bequest means, at the moment, the emergence of taxable ability which had not existed before and would not appear again except through repetition of similar receipts. Actually, there is in many cases a diminished ability because of the loss of the breadwinner, the executive head of the family estate, the main cohesive force in family affairs. Under an estate tax no account can be taken of these real, though intangible, considerations.

DEVELOPMENT AND CHARACTERISTICS OF DEATH TAXES

Death taxes are not a modern invention. Such levies were used by the Romans, or even by earlier nations, and there was some discussion of the subject, together with some fragmentary applications of the tax, during the Middle Ages. Their development on an extended scale and in a sufficiently systematic manner to produce significant revenue is a matter, however, of the last generation or so.

State inheritance taxes. In the United States the inheritance tax movement may be said to date to about the year 1885, at which time this tax was still, as Professor Bullock has observed, a "fiscal curiosity." There had been sporadic experiments with inheritance taxes in different states prior to this date, but the net result to that time appears to have been the

of this state, etc....shall be subject to an inheritance tax..." The rates are, of course, graduated.

imposition by two or three states of light taxes on bequests passing to collateral heirs. The enactment of the New York law of 1885 was followed by the introduction of a similar tax in more than twenty states by 1900, and at the present time Nevada is the only state without some kind of death tax. Certain characteristics of this development may be briefly summarized.

The classes of heirs taxable. Three classes of heirs are usually distinguished, direct, indirect or collateral, and strangers. Direct heirs are those in the direct family line, such as children, direct ancestors, husband or wife. Collateral heirs are relatives not of the direct line, such as brother, sister, uncle, aunt, cousin, nephew or niece. The first phase of the inheritance tax movement in the American states was the taxation of property passing to collateral heirs. All of the taxes introduced prior to 1891 applied to collateral heirs only. The interpretation of this term was not always uniform. Brothers and sisters, and also nephews and nieces, have been regarded by some laws as direct heirs, and by others as indirect or collateral heirs.

The extension of the tax to bequests received by direct heirs began with a New York law of 1891. This example was likewise followed rapidly by other states and direct heirs are now exempted only in New Hampshire. The early taxes on direct heirs were sometimes restricted to legacies of personal property, from which liberal deductions were permitted. The modern taxes apply to all property transferred.

There has been a tendency, also, toward the reduction of the exemptions allowed to all classes of heirs. The problem of exemptions proved rather difficult in some states by reason of the judicial construction of constitutional provisions relating to uniformity or equality of taxation. Some of the earlier laws taxing direct inheritances were held to be unconstitutional in various states on account of these local provisions.

Progressive rates. Another characteristic of inheritance tax development has been the increasing popularity of progressive rates. The federal Civil War tax was graded according to relationship and progressive according to the size of the shares, but Ohio has the credit of introducing, in 1893, the first progressive state inheritance tax schedule. This act was held unconstitutional two years later, with respect to the progressive feature. The fate of progressive rates hung in the balance until the decisions rendered by the Illinois courts and sustained by the United States Supreme Court established the principle that progression plus exemption was not a denial of the equal protection of the laws, nor an abridgment of the privileges and immunities of citizens of the United States.² The spread of progression may be seen in the fact that in 1908, of the twenty-

² *Kochersperger vs. Drake* (167 Ill. 122); *Magoun vs. Illinois Trust and Savings Bank* (170 U. S. 283). Cf. the review of these cases in M. West, *The Inheritance Tax* (1908), p. 179.

two states then taxing direct heirs, only six imposed the tax at progressive rates; whereas in 1942, thirty-five states were taxing direct heirs, and all but four of these had adopted progression on this class. Fifteen of the thirty-eight states taxing collateral inheritance in 1908 were then using progressive rates, but in 1942 thirty-five states taxed collateral heirs and in all but five the rates were graduated. New Hampshire taxes collateral heirs only, and at a flat rate of 9.5 per cent. Vermont taxes this class at 5 per cent, with no exemption, while direct heirs are allowed an exemption of \$10,000 and the rates range from 1 to 5 per cent.

There is great diversity among the states in the rate scales, the brackets and the exemptions. The highest rate on direct heirs in 1942 was 16 per cent. It applied, in Kentucky, to amounts above \$12,000,000, and in New Jersey to amounts above \$3,700,000. North Carolina taxed amounts above \$3,000,000 at 12 per cent, while Idaho levied 15 per cent on amounts over \$500,000. Rates of 20, 25 and even 40 per cent were levied in some states on amounts received by collateral heirs. Wisconsin, which has a 40 per cent maximum rate, limits the amount of tax paid by any beneficiary to 15 per cent of the whole property transferred.

The exemption to a wife ranged from \$5,000 in Ohio and New Jersey to \$75,000 in Kansas. The amount allowed to the husband or to minor children is everywhere less than to the wife.³ Bequests to charity organizations are everywhere exempted if the organization is within the state, but those passing outside the state are commonly taxed at the highest rate applicable to collateral heirs. Educational bequests to outside institutions are sometimes exempted on a reciprocal basis.

These variations in the state rates have largely lost their significance, from the standpoint of revenue as well as from that of conflicting state practices, under the provisions of the federal estate tax of 1926, which credited the taxes paid to the states against the federal tax due under that act.⁴

Multiple taxation. The widespread resort to inheritance taxation by the states after 1900 was marked by burdensome discrimination and retaliation which resulted in severe double and multiple taxation. The situation had become so acute by 1908 as to lead the National Tax Association to pass two resolutions condemning the practice, particularly in the case of the inheritance tax, and urging the repeal of all state retaliatory tax legislation.⁵ The principal difficulty arose in connection with the taxation of personal property, especially intangibles. It is generally agreed that the inheritance tax on the devolution of real property should be collected by the state in which this property is located. But the states

³ Collateral heirs are naturally granted still smaller relative exemptions, and some of the states allow no exemptions whatever to this class.

⁴ *Infra*, pp. 492, 505.

⁵ *Proceedings of the National Tax Association*, 1908, pp. 25, 26.

have been unable to agree as to the proper situs of personal property when transfer of this form occurs. In *Frick vs. Commonwealth of Pennsylvania* (268 U. S. 473), decided June 1, 1925, the right of a state to tax tangible personal property situated outside its borders was denied. The case of intangible personal property alone remained at that time to cause trouble. For the purposes of the property tax intangible property is considered to be taxable at the domicil of the owner, but some states extended the inheritance tax to intangibles owned by non-residents when the actual evidences of ownership were held within the state, as in the case of bank accounts, securities in safety boxes, mortgages on real estate, whether located within or without the state, and stocks issued by domestic corporations. The state of the decedent's residence invariably included all intangibles in the amount upon which it levied the tax, so that multiple taxation of inheritances was common.

The conflict had, also, a geographical and economic basis. Residents of eastern states control the bulk of the country's capital, the investment of which is widely distributed. These states naturally incline toward the taxation of the intangible evidences of ownership according to the residence of the deceased owners thereof. The western and southern states sought to tax these evidences of ownership to the extent that the property which they represented was located within their borders, or to the extent that the corporations issuing stock certificates had been chartered by them. The still more extreme position of taxing transfers of stock from a non-resident decedent to a non-resident beneficiary when real property belonging to the corporation was situated within the state was rejected by the courts. The policy of taxing transfers of stock by the states in which the corporations have been chartered ignores the true nature of the legal rights and interests of the owner of corporation stocks in the assets of the corporation, as well as the nature of the obligation of the citizen to pay taxes. It simply is a case of seizing upon whatever pretext may be at hand for the imposition of a tax.

As a direct result of the activity of the National Tax Association, the double taxation of intangibles has been largely eliminated, either through outright exemption of intangible property owned by non-residents, or through the acceptance of a reciprocal exemption policy. Under more or less uniform provisions, the enacting state agrees not to tax the intangible property owned by non-resident decedents, provided the state of the decedent's residence does not tax intangibles owned by residents of the state offering reciprocity. In 1942 seven states had not adopted this policy,⁶ the chief reason being, in some cases, that the state had chartered a conspicuously large corporation and there was a prospect of taxing, at some time, the transfer of a substantial block of the shares.

⁶ These were Arizona, Arkansas, Montana, North Carolina, South Dakota, Texas and Utah.

This prospect was considerably diminished by a decision of the Supreme Court in 1932 to the effect that shares of stock can be constitutionally subjected to death tax by but one state, and in the case at bar, this was held to be the state of domicil.⁷

It is possible, however, for the Court to find, in other cases, that intangibles had been so used in connection with a business in another state as to acquire a business situs there, and under this situation the situs for death taxation might be held to be the state in which the intangibles were located, rather than in the state of the owner's domicil. Under the reciprocity arrangements as originally developed, such intangibles might escape all taxation, for the state of domicil could not tax them, and the state of their location would not do so under its reciprocity arrangement. New York and some other states have amended their reciprocity law to exclude from it any intangibles owned by non-residents to the extent that they may have acquired a business situs within the state. This will not mean double taxation, for under these circumstances, the state in which the situs is acquired would be the only state in which they could be taxed.

The antics of some persons with large estates have thrown the estate tax situation into turmoil in recent years. These antics have consisted of shuttling about from one state to another, under the inspiration of bad legal advice rather than whim, for the purpose has not been the pursuit of pleasure but rather an over-smart juggling among the states with respect to residence and domicil, local tax avoidance, legal provisions concerning the creation of trusts, and similar matters.⁸ The Supreme

⁷ *First National Bank of Boston, Executor of the Estate of Edward H. Haskell, Deceased, vs. State of Maine*. Cf. *Proceedings of the National Tax Association*, 1932, pp. 180-184.

⁸ Cf. the following, from the remarks of J. W. Hickey, chief inheritance tax attorney for the state of California:

"...the Dorrance cases arises because of the tactics of Mr. Dorrance during his lifetime.

"He was in business in New Jersey but wanted to live in Pennsylvania. He moved to Pennsylvania, and at the same time tried to maintain a residence in New Jersey, both for the purpose of taxation and because the statutes of Pennsylvania would prevent him from disposing of some part of his property by will the way he desired to.

"The Trowbridge case, another horrible example (i.e., of double estate taxation) arises by reason of the fact that Mr. Trowbridge wanted to live in Connecticut and tried to maintain a residence in New York.

"In the Hunt case, Mr. Hunt lived here in California and endeavored to maintain a residence in Massachusetts.

"In the last case, we have a Colonel Greene, who first rented a room in Texas and moved back East and tried to maintain his residence in Texas. He built a palatial home and had a pretentious estate in Massachusetts but wouldn't stay there more than six months because he would have to pay an income tax in Massachusetts, and so he migrated between Florida, New York, and Massachusetts.

"We find that this question of double domicile arises after death, because of the tactics of the decedent during his lifetime.

"The laws of domicile in the various states are, with minor exceptions, uniform, and I think it is agreed that a man cannot elect one domicile for the ordinary pur-

Court has sanctioned the imposition of inheritance or estate taxes by more than one state upon the same property on the ground that a person may have more than one domicil.

Taxes on estates. The basic form of the state death tax has been that on the inheritance; but a number of states have also introduced an estate tax, while some of them now tax only the estate. The states using both the inheritance and the estate tax have introduced the latter for the purpose of absorbing the difference between their own tax on inheritances and the 80 per cent credit allowed by the federal act of 1926.⁹ Those states that have not enacted supplementary estate taxes are now levying rates on inheritances which in many cases are sufficient to absorb any differential under the federal law.

Administration of state death taxes. The administrative organization varies widely among the states. Originally the tax was administered locally, usually by the probate court with which the will was filed. It is still administered locally in Louisiana, Maryland, Missouri, Nebraska, and Texas. Centralization carried the administrative responsibility for inheritance taxation into various state offices. Instead of placing it uniformly with the state tax department, it was given to the state treasurer in Iowa and Oregon, to the attorney general in Illinois and New Hampshire, to the auditor in Idaho and Michigan, and to the controller in California. Although Kansas has a tax commission, a separate inheritance tax commission was established for this tax, and Wyoming provided an inheritance tax commissioner.

Emphasis has already been laid on the necessity of competent state tax administration,¹⁰ and there is no good reason why this department should not be made responsible in every state for the operation of this tax. To do otherwise is to ignore the fundamentals of good administrative organization.

The federal estate tax. The federal government made three brief experiments with death taxes prior to 1916, but in two cases the tax was confined to personal property. Stamp taxes were imposed in 1798 on legacies of personal property in excess of \$50. This tax was repealed in 1802. The Spanish War tax on inheritances was likewise restricted to the distributive shares of the personal estate. The Civil War taxes on inheritances included both legacy and succession duties. These terms are used, especially in England, to mean, respectively, a tax on the transfer of personal property and a tax on the succession to real estate.¹¹

poses of life and another for the purposes of taxation." In *Proceedings of the National Tax Association*, 1939, p. 430.

⁹ *Infra*, p. 492.

¹⁰ *Supra*, Ch. XIX.

¹¹ The federal income tax act of 1894 provided for the taxation of inheritances as income. This form of receipt is now universally excluded from gross income, although the income from gifts and bequests is properly to be included.

The present phase of federal death taxation began with the estate tax of 1916, which imposed graduated rates rising to 10 per cent on net estates above \$5,000,000. Subsequent acts passed during the first World War advanced the rates but they were reduced and temporarily stabilized in 1926. For estates becoming taxable after the passage of the 1926 act, the maximum rate was to be 20 per cent on the amount above \$10,000,000. This act advanced the exemption to residents from \$50,000 to \$100,000.

The act of 1924 had authorized a credit against the federal tax due, of the amount of state inheritance or estate taxes paid on property included in the gross estate, up to 25 per cent of the federal tax levied. This credit was raised to 80 per cent of the federal tax in 1926. As noted above, a number of the states have since levied supplementary taxes or adjusted their inheritance tax rates so as to absorb all, or substantially all, of the available credit. The estate is not taxed more heavily, in the aggregate, but a greater share, up to four-fifths of the federal tax, as determined by the 1926 rates, is thus apportioned to the states rather than to the federal treasury.

The establishment of the crediting device has given the act of 1926 a certain fixed importance. No further change in rates was made until 1932, when an additional estate tax was introduced, against which the state taxes were not to be credited. The procedure introduced for computing the total tax which was then devised has since been followed. It requires, first, the computation of a tentative tax on the net estate at the rates of the current act, which were increased in 1932 to 45 per cent on sums in excess of \$10,000,000; and second, the computation of a tax on the estate at the rates of the 1926 act. The additional tax to be paid is the difference between the two taxes thus computed. State taxes are of course credited only against the tax as computed under the rates of the 1926 act, and not against any of the later increases of federal tax.

Legislative changes since 1932 increased the rates still further. Under the latest enactment, in the act of 1941, the maximum rate is 77 per cent, applicable to that part of the net estate in excess of \$10,000,000. The beginning rate is 3 per cent, on the first \$5,000 of net estate. The exemption under the additional tax is now \$60,000.

The federal estate tax applies to the transfer of the net estate of every citizen or resident of the United States, and except as otherwise provided, to the estates of non-residents who are not citizens. The net estate is to be ascertained by deducting certain items from the gross estate. The value of the gross estate includes the value of all property, real or personal, tangible or intangible, wherever situated, except real property situated outside the United States, to the extent of the rights or ownership in such property that were vested in the decedent at the time of his death. Prior to 1935 the valuation was to be made as of the date of death, but the act of 1935 permitted the executor to choose, at the time of filing his return,

whether to declare the value as of the date of death or as of a date one year thereafter. The time of filing the return is set by the regulations and not by the law, but if it must be submitted earlier than twelve months after the date of death, the option authorized will cause uncomfortable moments for many administrators.

Further, the gross estate shall include the dower or curtesy rights of the surviving spouse, the decedent's interest in joint estates, and all property passing under power of appointment vested in the decedent. A power of appointment, as used in death tax laws, means the right or power to name, that is, to appoint, the beneficiary who is to receive the property following the person exercising the power. Such a power is deemed to indicate as complete a right of disposition as if the full title to the property concerned were vested in the person exercising it.

The gross estate also includes all insurance on the decedent's own life that is payable to the estate, and a part of all insurance payable to other beneficiaries proportionate to the premiums paid thereon by the decedent.

For the purpose of determining the net taxable estate, the deductions from the gross estate that are allowed to a citizen or resident of the United States include: funeral expenses; the costs of settling the estate, including an allowance for the support of the decedent's family; losses incurred but not compensated by insurance; taxes other than income and inheritance taxes, although the latter, when levied by the states, are allowed as a credit within the limits set by the act of 1926; an amount equal to the value of property, received from the estate of a prior decedent who has died within five years, if an estate or gift tax had been paid on this property under an act of Congress; bequests to governmental units or to corporations organized for religious, educational or charitable purposes; and a specific exemption which is now \$60,000. The bequests to non-profit welfare organizations will not be allowed if any part of their activities consists in carrying on propaganda, or otherwise attempting to influence legislation. This qualification is disingenuous, at best. It offers many opportunities for arbitrary distinction based on political or ideological grounds, for the only definition of "propaganda" that will satisfy everyone is that it is the stuff put out by the other fellow. One's own material is always educational.

The deductions allowed in determining the net estate of non-residents other than citizens refer to similar objects, but they must be apportioned to the relative value of the estate within and without the United States. Prior to 1928 the aggregate deductions could not exceed 10 per cent of the gross estate situated in the United States. No specific exemption is allowed.

Double taxation. The question of the situs of property for death taxation, which has produced so much discrimination, retaliatory legisla-

tion and multiple taxation of inheritances in the case of the states has not been dealt with in a satisfactory or wholly equitable manner by the federal government. While any national state is legally competent to adopt such rules of property situs as it may determine, the interests of international comity and fair dealing require that reasonable adjustments be made to avoid international double taxation of estates, just as such adjustments have proved necessary among the states. This can be accomplished, however, only by recognizing that concessions in the interest of equity should be made, even if they involve some loss of revenue. Some of the states faced this unpleasant aspect of the problem in adopting the principle of the reciprocal exemption of intangible property owned by non-residents.

The rules of situs that are now operative among the states appear to be applicable among nations. Real property and tangible personal property should be taxed where situated, and intangible property should be taxed according to the domicile of the owner. The federal policy does not square up well with these rules, although it has been improved in certain respects. Under the earlier laws, the gross estate included, in the case of every decedent, real property and tangible personal property wherever situated, that is, whether within the United States or without. The stock of domestic corporations owned and held by non-resident decedents, and the amount receivable as insurance on the life of a non-resident decedent where the insurer was a domestic corporation, were expressly declared to be deemed property within the United States. Under the rules of situs now applicable to the states, none of these items of intangible property would be included, in the case of non-residents. The act of 1921 removed the proceeds of insurance policies on the lives of non-residents, and the act of 1934 eliminated from the gross estate real estate situated without the United States. The stocks of domestic corporations remain, although the only shadow of excuse is the fact that the corporations are chartered here, a contention that the Supreme Court would not accept from a state, unless there might be proved a positive and definite integration of the intangible property with a business conducted therein. Even so, the domicile of the corporation would have nothing to do with the taxable situs of the intangible property.

In another instance an arbitrary rule of situs is provided that may lead to double taxation under some circumstances. The law declares that any property of which the decedent has made a transfer by trust or otherwise, of a sort that comes within certain provisions relative to revocable trusts and to grants intended to take effect at death, shall be deemed to be within the United States if so situated, whether at the time of the transfer or at the time of the decedent's death. Such transfers, when made by non-residents, may result in double taxation on account of the rule of situs here established.

THE FISCAL RESULTS OF DEATH TAXES

The revenue yield of state and federal death taxes for recent years is shown in Table XLV.

The aggregate collections by the states have been, during the past decade, a moderate and declining proportion of all state taxes. The relative contribution of this method of taxation to the total federal revenues, has been even less than in the case of the states as a whole, a result which has necessarily followed the practice of crediting state taxes against the federal tax due. The decrease in federal collections after 1926 registers the progress made by the states in legislating to absorb the full credit allowed. The arrangement resulted in doubling the state death tax revenue between 1926 and 1930, and in some increase in the ratio of inheritance taxes to total state taxes collected. The depression caused heavy shrinkage in estate valuations and consequently in the revenues obtainable, even under heavier rates. The federal gift tax revenues have been wholly negligible in amount.

TABLE XLV

STATE AND FEDERAL COLLECTIONS OF DEATH AND GIFT TAXES SINCE 1924, AND
RATIO OF SUCH TAXES TO TOTAL TAXES
(THOUSANDS OF DOLLARS)

Year	All States *		Federal Government			
	Death and Gift Taxes	%	Death Taxes	%	Gift Taxes	%
1924	\$ 79,308	7.8	\$102,967	3.7	.....	..
1928	127,538	8.4	60,087	2.2	....	..
1932	149,416	9.1	47,422	3.0	.. .	..
1936	114,903 †	3.7	218,781	5.3	160,059	4.0
1940	112,996	3.4	330,886	6.1	29,185	.54
1944	114,000	2.8	473,465	1.0	37,745	.83
1945	132,000	3.1	596,137	1.3	46,918	.10

* The state figures are from the Census Bureau's publication, *The Financial Statistics of States*. The totals do not include the inheritance tax receipts apportioned locally. The federal figures are from the *Annual Report of the Secretary of the Treasury*, 1945.

† Figures for 1937. Data for 1936 not available.

The advantages of state inheritance taxation, from a revenue standpoint, are very unevenly distributed, as would be expected in view of the differences in the relative concentration of wealth ownership among the states. In the peak year of state collections, 1931, six states received \$137,-691,000, or 75 per cent of the total.¹² For these states the tax represented

¹² These states, and the amount collected by each in thousands were: New York, \$52,691; Pennsylvania, \$38,640; California, \$13,736; Massachusetts, \$11,689; Illinois, \$10,708; and New Jersey, \$10,227. *Financial Statistics of States*, 1931, Table 7.

a much greater proportion of all state taxes than the average, and therefore than that realized in many of the states.

PROBLEMS PRESENTED BY DEATH TAXES

The administration of death taxes, whether based on the distributive shares or on the entire estate, involves many problems and difficulties. Some of the more conspicuous of these will be outlined briefly, although the account of the manner in which they have been approached must frequently be inadequate through the enforced omission of necessary technical details.¹³

Transfers made in contemplation of death. Since a death tax is imposed on the transfer of property at the death of its owner, an obvious procedure for the legal avoidance of the tax would be to give the property, or some of it, before death. The heavier the estate or inheritance tax, the greater is the incentive to make distributions before death. Persons with large estates can afford to do this without sacrificing their own security, and they have the greater reason for doing it.

Transfers *inter vivos*, that is, among the living, were often made to avoid the earlier death taxes. Two plans have been developed for dealing with them.

One plan was to provide that if such transfer occurred within some stated period prior to the date of death, it should be deemed to be made in contemplation of death, and hence should be taxed as if it had actually been made at death. Nearly all states tax transfers in contemplation of death. A definite period was usually set and a transfer within the stated period prior to death was regarded either as *prima facie* or conclusive evidence of its being made in contemplation of death. In the states which set no definite period, each transfer *inter vivos* was to be considered in the light of the evidence. The earlier federal laws contained a two-year period, within which a transfer constituted *prima facie* evidence, but the act of 1926 changed the *prima facie* presumption to a conclusive one.

The courts have always been dubious about accepting such an arbitrary determination of intention, and the Supreme Court finally rejected a fixed period in a state statute as conclusive evidence of intention, since the taxpayer was not allowed to offer rebuttal proof.¹⁴ These decisions diminish the possibility of further state enforcement of such provisions, since it is always extremely difficult to obtain evidence as to what may have been in the donor's mind, and it is now virtually necessary to prove the motive.

¹³ In the preparation of this section, and of the whole chapter, the report by the staff of the Joint Committee on Taxation, *Federal and State Death Taxes* (1933), has been helpful.

¹⁴ *Schlesinger vs. Wisconsin*, 270 U. S. 230 (1926); the federal provision was rejected in *Heimer vs. Donnan*, 52 S. C. 358 (1932).

Gift taxes. The other plan of dealing with transfers among the living is by a tax on gifts. Such a tax is not imposed simply on those transfers thought to have been made in contemplation of death, but on all gifts whenever made. A federal gift tax was enacted in 1924 and repealed in 1926. It was imposed on the transfer of a gift, and the tax was to be computed annually on the total amount of net gifts made during the year in excess of an exemption of \$50,000. The rates ranged from 1 per cent on the first \$50,000 to 40 per cent of the excess over \$10,000,000. This tax produced \$7,518,000 in 1925 and \$3,175,000 in 1926. Although generally regarded as unconstitutional, the Supreme Court upheld it in 1929.¹⁵ As a bulwark of the material increase of estate tax rates in 1932, the gift tax was restored but in different form, and the rates have been advanced as the estate tax rates were increased. The tax applies to all transfers in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible. Gifts by non-residents are taxable only if the property is situated in the United States, and the notorious provision of the estate tax law is repeated with respect to the situs of stocks of domestic corporations.

Citizens and residents are now allowed one specific exemption of \$30,000 but gifts not exceeding \$3,000 to any one person in any year are not taxed, nor do they count within the \$30,000 exemption, gifts to governmental units and to non-profit organizations are deductible. On the net gifts, which is the total minus these deductions, the tax in any year shall be the excess of (1) a tax on the gifts in that year plus all gifts made in prior years, over (2) a tax on the aggregate sum of the net gifts for each of the preceding years. The effect of this arrangement and its purpose, is to produce the same tax burden, whether the gift is made in a lump or is made over two or more years. It may be illustrated as follows in the case of a gift of \$4,000,000, in excess of the specific exemption.

<i>Year</i>	<i>Amount of Annual Net Gift</i>	<i>Tax on Cumulative Annual Net Gifts</i>	<i>Tax on Aggregate Gifts of Prior Years</i>	<i>Tax on Current Gifts</i>
1936	\$1,000,000	\$ 92,125	.....	\$ 92,125
1937	1,000,000	239,625	\$ 92,125	147,500
1938	1,000,000	417,125	239,625	177,500
1939	1,000,000	624,625	417,125	207,500
Total tax if spread over four years				\$624,625

Thus it results that a gift of \$4,000,000 would be taxed in the amount of \$624,625 at the rates applicable to the years 1936-1939, whether made in one sum or spread over a period. Under the plan of gift taxation in the 1924 act, the gifts of each year were taxed independently of prior gifts,

¹⁵ *Bromley vs. McCaughn* (280 U. S. 124).

thereby permitting the distribution of a large amount, through the years, at lower rates. This device prevents that method of avoiding heavier taxation.

The brackets for federal estate and gift taxes correspond, but the rates for the latter are uniformly 25 per cent lower than for the former tax.

Eleven states had introduced gift taxes by 1942, using rates and brackets similar to the state death taxes imposed. In view of the uncertainty of the future of taxes on transfers in contemplation of death, more states may be expected to follow this lead.

Inheritance versus estate taxes. There is no clear preponderance of the argument as between the two methods of imposing death taxes. Each offers advantages and disadvantages which differ in kind as well as in degree, and which cannot therefore be conveniently balanced against each other. They may be summed up by saying that the tax on the distributive shares tends to fall more equitably on all beneficiaries according to their respective shares, while a tax on the estate is more easily administered. There is thus a conflict between the convenience and ease of application and the weight of the tax.

If the tax is levied on the estate, with no provision in the will for its payment or apportionment, each share will be diminished by a pro rata part of the tax. Obviously the tax borne by the several beneficiaries will be heavier in proportion as the size of the estate increases, although some shares may be no greater in a large than in a small estate. For example, under the present federal law, a person inheriting a net estate of \$100,000 would pay \$20,700; if he inherited \$100,000 from a net estate of \$200,000 his share of the tax would be \$25,350; but if he inherited \$100,000 from an estate of \$10,000,000, his proportionate part of the tax would be \$60,882.

On the other hand, the taxation of the shares presents some difficult questions, both of administration and of equity, particularly in the case of future interests. A future interest is created when one person inherits a life interest in property which, at his death, is to pass to another. The first beneficiary is called the *life tenant* and the second is the *remainderman*. A National Committee on Inheritance Taxation, reporting in 1925, advised that the states generally should substitute estate for inheritance taxes.¹⁶

One important consideration was the superior administrative simplicity of the estate tax, particularly with respect to the elimination of the valuation of separate interests. The responsibility for correcting the disparity of burden among beneficiaries should be assumed, it was contended, by the testator, who should plan his bequests more carefully and make specific provision for tax payment. Some improvement could no doubt be effected if more forethought were to be taken, but no amount

¹⁶ *Report of the National Committee on Inheritance Taxation*, 1926, pp. 34-39.

of planning could have prevented inequalities of incidence after 1929, in view of the severe shrinkage of estate values.

Valuation of the property. Prior to 1929 no severe depreciation of values had occurred since the death tax movement had become widespread and vigorous, and neither the law nor the administrators were prepared for what happened to property values during the depression. Death taxes, like the ordinary property tax, are levied on an assessment of the capital value. The date as of which the valuation is to be made is, naturally, the date of death. It has long been recognized that any violent variation in market values would be likely to affect either the government or the taxpayer adversely. If there is a sharp decline in values after the date of death, a tax computed on the value as of that date may absorb virtually all of the estate; if there is a sharp advance, the estate gains while the government loses by computing the tax as of the date of death rather than as of the date of distribution.

No entirely satisfactory solution for this dilemma appears, short of controlling the fluctuations of the business cycle, a remedy which has hardly advanced as yet beyond the stage of a statistician's dream. The federal law of 1935 authorized the administrator to select, if he chose, the date one year after death, but if he must make this decision in advance he will be most severely criticised by the heirs for electing the later date in case values rise, and for not taking it if values should fall during the year.

The staff of the Joint Committee on Taxation has proposed a procedure for determining the effective rate that would afford substantial relief.¹⁷ It involved the computation of a tax on the estate, at the rates in force on the date of death, and the determination of a composite rate of tax on the whole. In ascertaining the final tax liability, which it was proposed to do one year later, this composite rate was to be applied to the actual value of the estate on the later date. This plan was "predicated on the thought that Congress never really intended to deprive the heirs of a fair portion of the estate." But it was dated February 2, 1931, and even at that time had no response. Three successive increases were quickly made in the rates, and only in 1935, after the worst of the depression storm had passed, was the administrator given an option as to the date of valuation. Evidently the plan presumed too much as to the intention of Congress.

Whether in good or in bad times, however, the administration of death and gift taxes based on property valuation involves the determination of fair property values, a process which encounters all of the difficulties and all of the opportunities for inequality of assessment that are presented in the case of the property tax. Although inheritance and gift tax laws do not ordinarily so state, the presumption is that value means,

¹⁷ *Federal and State Death Taxes*, pp. 254-256.

in these laws as in property tax laws, "market value," the amount that could be realized in a voluntary sale transaction.

Considered from this viewpoint, and in the light of the experience with ordinary property assessments, the opportunities for inequality and discrimination under such laws are enormous. The ruthless advances in rates have ignored the imperfections of administrative technique, while they have stimulated the efforts to escape, precisely as the advance in property tax rates stimulated evasion. Local officers and federal agencies are alike relatively unqualified for the task of determining fair market values. The best qualified agency in the United States for assessing property under death or gift tax laws is that state tax commission which is sufficiently alert, vigorous and conscientious in its supervision of and contact with local assessors to have a proper conception of property values and of the assessment technique. Not all of the existing commissions can fully meet this test, today, but most of them are no doubt better qualified than the other state officials who have been saddled with the responsibility, or than the local officers who are still responsible in some states, or than the federal tax officials in charge of estate taxes. Consequently, there is beyond doubt considerable discrimination in the assessment of gifts and estates, which may be either intentional or unintentional.

Community property. An interesting situation, under income as well as estate and inheritance taxation, is presented by the laws relating to the property interests of husband and wife in certain southern and western states. This is the system known as community property. It was derived, either directly or by adaptation, from the legal systems of Spain and France.¹⁸ The theory of community property is that husband and wife each own equal shares of any property acquired or income received during the marriage relationship. The particular rights are set out in each state in the constitution and statutes. The federal government has thus far regarded itself as bound by these provisions in the application of its income and estate taxes.

The local provisions vary somewhat in scope, but the federal practice has been to include only one half of the community property in the gross estates of decedents in Arizona, Idaho, Louisiana, Nevada, Texas and Washington. A similar practice has been observed with respect to the federal income tax in some of these states, with the sanction of the Supreme Court. In New Mexico the wife's interest is regarded as a mere expectancy. Consequently no tax is imposed on the community property when the wife dies but it is all included in the gross estate at the death of the husband. The attorney general ruled that the wife's interest in California was only an expectancy, but the legislature enacted a correc-

¹⁸ The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington.

tion in 1927, although it is not certain that this would be accepted as a corrective of the prior situation.

In view of this division of the community property between husband and wife the amount of estate tax is, of course, diminished. The relative advantage is said to be unfair to the citizens of other states, but this is not a reasonable view. If one half of the property acquired during marriage actually belongs to each, why should the government expect to tax the whole when the husband dies? Estate tax laws are not ordinarily based on a conception of family property. Each owner is taxed simply on the transfer of his own property. The property owned by either spouse at marriage is not included in the other's gross estate at death unless there has been a gift or a bona fide transfer for adequate consideration meantime. If community property means an actual title and ownership interest, as it presumably does, no one can have any complaint over the result. It keeps the estate tax down, but this is also the result when both parties bring property to the family relationship in other states, rather than having complete ownership vested in one or the other.

Dower and curtesy. The rights of dower and curtesy raise a minor question of similar tenor to that raised by community property, although the two types of right acquired at marriage are sharply different. *Dower* is the right or interest which a woman acquires, at marriage, in the real property owned by her husband on the marriage date, and *curtesy* is the similar right acquired by a man in the real property of his wife at marriage. These rights originated under the common law. They never existed in the community property states, or they have been abolished there in favor of the community property conception of the rights acquired during marriage. Twelve states have abolished both rights, and five others, Georgia, Florida, Missouri, Montana and South Carolina have abolished or have never allowed curtesy. One or both rights are therefore recognized in twenty-eight states.

The federal estate tax law requires that any such rights, or any statutory estate in lieu thereof, enjoyed by the survivor, be included in the gross estate of the deceased spouse. Ten of the states tax both rights under their inheritance or estate taxes, and six states exempt both rights in full. Arkansas taxes the value of the dower above \$6,000, and of the curtesy above \$5,000. Of the states which recognize the dower only, Missouri and South Carolina exempt it. New York exempts the dower, but taxes the right of curtesy.

The taxation issue raised is similar to that involved in community property, although the amounts of taxable estate and revenue affected are less, since the dower and curtesy rights, where recognized, would not be as large in amount, on the average, as one half of the community property.

The issue cannot be dismissed by generalization, although the weight

of judicial opinion seems to be that such interests are taxable as part of the estate of the deceased spouse. From the standpoint of equity, the matter would appear to depend on the reality of these rights. So far as the applicability of the estate tax is concerned, the reality of the right should depend, not upon the degree of participation in the control or management of the property in which the right existed, or even in the income derived from it, that was enjoyed by the one in whom the right vests, but upon the definiteness and certainty with which an estate by dower or by curtesy is acquired prior to the death of the other spouse. If, under the law of any state, such estate is acquired by the marriage contract, it is futile to assume that the decedent conferred it by transfer, or that he or she had the power to transfer it, or that such transfer was essential to complete the title. If no transfer is made or if none is in fact necessary with respect to the estate by dower or curtesy, there can be no occasion for a tax based on the transfer, for this means taxing something that did not and could not happen.

Power of appointment. The expression, *power of appointment*, means the right to designate or appoint the beneficiary who shall succeed the person exercising the power. Such power may be general, which gives the donee absolute discretion and is therefore equivalent to ownership, or it may be limited, as when appointment is required from a restricted class of persons such as children or other classes of relatives. In this case ownership is not complete.

The federal law requires the inclusion of property in the gross estate only when the power of appointment with respect to it is general. That is, if *A* gives property to *B* and stipulates that *B* shall appoint *C*, there is no tax when *B* dies. Transfers with limited power of appointment are in general analogous to life estates, and the succession of a designated appointee, like the succession of the remainderman, is not a true transfer.

Trusts. The taxable status of property that has been put in trust, which means that the title has been transferred to a trustee with instructions for the application of the income and for the ultimate disposition of the property itself, has involved problems everywhere under inheritance and estate tax laws. The reason for this is that it is not a transfer at death, in all cases, nor is it always a transfer made in contemplation of death. Hence the ordinary logic of death taxation does not always apply.

If the trust is created under a will it is a testamentary trust, and no question arises, since it is clearly a transfer at death. If it is created during life, it is a living trust, and the issue of its taxation depends on whether or not the transferor retained the power to revoke it or yielded this power. In the latter case it is an irrevocable trust, under which various possibilities arise. For instance, the creator may reserve the income to himself for life, or he may give the income to his wife or to someone else for life, with provision that at the death of the donee, the property shall pass to

another. If the donor reserves the income to himself for life, he has only a life interest in the estate thereafter. If he gives the income to another, he has divested himself completely of it. Whether the donee has complete ownership will depend on his right to name, or appoint, the succeeding beneficiary.

In 1930 and 1931 the Supreme Court decided that certain types of irrevocable trust were not taxable under the act of 1926, since they were not created in contemplation of death. Congress responded by amendments to the acts which included in the gross estate a transfer under which the transferor has retained for his life or any period not ascertainable without reference to his death, or for any period which does not in fact end before his death, either the income or the right to designate who shall possess the property or the income therefrom.¹⁹

This provision is logical enough so far as concerns the power of appointment, for the donor has not made a complete surrender of ownership, even under an irrevocable trust, while he retains the right to designate the succeeding beneficiary.

The case is different when the power of appointment is surrendered. Although the income may be retained for life, it seems to the layman that this situation should be distinguished from the other, for the transferor in such case, after signing the trust deed, has only a life interest in the property. The succession is determined from the day the trust becomes effective; the decedent has nothing to transfer at death, for his entire interest, which is only a right to income during life, terminates at death; hence there is nothing belonging to him at death and nothing done by him, except to die.

The legal situation with respect to trusts is confused and complicated. It involves the income tax, the gift tax, and the estate tax. As the court decisions and the law now stand, it is possible, for example, to create a trust under which the donor has no income tax liability, although the corpus of the trust may be put into his estate at death. Or he may make a type of transfer which would leave him subject to income tax while removing the property from his gross estate.

It would appear logical to devise a set of rules under which the liability for income tax would be clearly set forth, on one hand, and the liability for either gift tax or estate tax would be as clearly set forth. Professor Erwin Griswold has outlined such a plan.²⁰ In essence, the beginning would be the determination of income tax liability. If the transfer were in any material degree short of complete, the donor would continue to be liable for income tax. In this case there would be no gift

¹⁹ *Revenue Act of 1932*, Section 803.

²⁰ Erwin Griswold, "A Plan for the Coördination of the Income, Estate and Gift Tax Provisions with Respect to Trusts and other Transfers," 56 *Harvard Law Review*, 340 (1943).

tax, and the property would be included in his estate at death. On the other hand, if the transfer is sufficiently final and complete as to relieve the donor of income tax liability, then it would be subject to the gift tax and would not be included as part of the estate at death. This plan would recognize the gift tax for what it is, namely, a tax on transfers made during life. It should be regarded as a substitute for the estate tax, not simply as a preliminary and partial installment paid on account of the death tax. The historic policy of setting a lower scale of gift tax rates indicates a disposition to promote and encourage the transfer of property during life by offering a premium in the amount of the rate differential.

Credit for prior estate and gift taxes. When property is transferred and the donee has general power of appointment, its transfer at the death of the donee is again taxed unless the last preceding transfer had occurred within five years. This is an arbitrary period, the basis of which probably is some vestige of the theory that the transfer of property should be taxed only once in each generation.

Most of the states have no safeguard against repetition of the tax in the event of the early demise of the beneficiary who has just inherited. Oregon exempts for one year, Iowa, Kentucky, North Carolina and Mississippi for two years, Idaho for four years, Alabama, California, New York, Tennessee and Washington for five years. Colorado and North Dakota give a five-year tax credit, Wisconsin allows a six-year tax credit to the widow's child, and Montana permits a ten-year credit to the widow.

Under the strict logic of the tax, which is levied on the transfer, the second and all succeeding transfers should be taxed when they occur, even if within the same month. But transfer at death, which is the occasion of the tax, is presumed to occur, on the whole, in an orderly manner that will involve a complete turnover of all property in each generation. A series of disasters or an epidemic may speed up this turnover in a given family and thus result in serious discrimination by comparison with the whole group of such taxpayers. To prevent this, some reasonable limitation is proper.

THE PLACE OF DEATH TAXES IN THE TAX SYSTEM

Until recently it could have been said that the question of the position of death taxes in the federal tax system was not open to argument. The Committee on Postwar Tax Policy took the position, in 1945, that the most desirable solution would be to permit this tax to revert to the states through repeal of the federal laws.²¹ The reasons advanced in favor of this position were, first, that the states had greater need of the revenue than the federal government, second, that this addition to their revenue

²¹ *A Tax Program for a Solvent America*, New York, 1945, Ch. 10.

would be, by so much, a contribution to the solution of federal-state fiscal relationships, and third, that the states are the grade of government which regulates the transfer of property and provides for the control of the administration of estates. A further consideration was that the states would develop and apply the tax as a bona fide revenue measure, whereas the federal policy has been, in large degree, one of penalizing the accumulation of wealth through severe estate tax rates.

If this counsel be not accepted, the Committee advised that the federal tax should be moderated by increasing the exemption and reducing the rates, the objective being to limit the tax to an amount that would permit the ordinary estate to meet its tax obligation without serious effects upon the continuity of going business concerns of the continuation of ownership and control in the hands of those designated by the former owner. These considerations apply principally to closely owned businesses. It is possible that in the zeal for the social reform to be accomplished by breaking up fortunes, the damage done through the disruption of competent control is quite overlooked. It was also advised that the rates remain stable over the years, to avoid penalizing those who happened to die in periods of high rates. The unusual suggestion was offered that there be no tax on transfers between husband and wife, with safeguards against marriages entered into solely to avoid the tax.

The origin of the device of crediting state taxes against the federal tax was unfortunate and for an unfortunate, even improper purpose. It was introduced at a time when the worst aspects of state competition in inheritance taxation were manifest, and, it must be admitted, prior to the demonstration of what could be accomplished through mutual concessions among the states. The real object was to nullify the fact that a few states had no inheritance tax and thus to neutralize any supposed advantage which they may have offered as a haven for those who could, by transfer of residence, effect a changed situs for property subject to the inheritance tax. The credit device accomplished nothing toward reform of the worst state abuses, such as multiple taxation through conflicting claims of situs. These have been dealt with by the states themselves.

It is urged in favor of this plan that under it the state inheritance tax revenue has more than doubled, as it did between 1926 and 1930. The states naturally legislated to absorb taxes that would otherwise have gone into the federal treasury, but some of them probably acted in the same spirit as did Nebraska, reflected in the following extract from the special estate tax law: ²²

Sec. 7. This act is not a commitment of the legislature to the principle of the coercive features of the Federal estate tax. It is accepted in order to protect the temporary interests of the people of the State of Nebraska.

²² Quoted in *Federal and State Death Taxes*, p. 221.

The refund, by the crediting device, of 80 per cent of all estate taxes levied under the 1926 act virtually nullified that act as a federal revenue source. When this arrangement was made the federal treasury was so well supplied with funds that it could afford the liberality. The transformation of the revenue outlook during the depression led to sharp increases in the rates in an effort to salvage something from this tax, and to the denial of further credits against the additional tax levied. Meantime, the depression had run true to form in producing the usual crop of economic and financial panaceas. They included increases in the estate tax rates, in the belief that this method and degree of taxation would correct social abuses and quiet social unrest.

There is still lacking a basic economic philosophy of estate and inheritance taxation, despite the appeal to the ability principle to justify some degree of taxation and some degree of differentiation in the tax according to the relationship of beneficiaries to the decedent. This is all that is, or can be accomplished by reference to ability. It indicates how much the beneficiaries may be expected to contribute, but it does not indicate how much government ought to take.

The economic effects of death taxation may be considered in two ways. The first relates to their influence upon economic motives, and the second to their consequences for the volume and the managerial organization of the nation's capital fund.

There would be general agreement that the motives and incentives to economic effort are diverse, and that the urge to accumulate, though very important, is not the only one worthy of consideration. Yet it can hardly be doubted that the frustration produced by the prospect of death taxes so severe as to expropriate a large part of the material fruits of one's life work is substantial, and that heavy taxes of this sort do have an adverse effect upon the vigor and intensity of the motives which induce men to work and to save.

The taxes levied at death do not immediately affect the volume of the nation's capital. If they are too heavy to be paid out of income, there must be a sale of a part of the assets. This means a transfer of ownership. As already noted, the result here may be a disruption of continuity of control, a passing of ownership to persons less interested in the future of the business or less competent to hold the course laid out. If capital is less wisely or less efficiently used, because of these enforced dispersions, the effect upon the economy is adverse. It is as if some of the capital had been destroyed.

CHAPTER XXIX

Some Effects of Taxation

IN CONCLUDING this general survey of the principles involved in the use of the taxing power and of the more important methods of taxation, it is appropriate to consider the effects of taxation. This is a difficult subject, the treatment of which cannot readily be supported by statistical or other factual data.

It is desirable to distinguish, if possible, between the results and the effects of taxation. The former refers to that which is accomplished as a consequence of the payment of taxes, the latter to the effect of this procedure on the economic condition, motives and attitudes of the taxpayers.

THE RESULTS OF TAXATION

The result of taxation, that which is accomplished through the exercise of the taxing power, is the provision of funds for the support of government. In other words, the principal result of taxation is to make possible the performance of public services by government. There is, thus, a direct relation between taxation and public expenditure. Judgment as to the wisdom and general utility of taking certain sums from the people through taxation cannot rest simply on the process of taking, that is, of taxing, but on the final social advantage that is realized from what government does with this money.

It is unnecessary to pursue this subject so far as to repeat what has already been said with respect to the advantages of government as a form of social organization. Its utility for the performance of services is sufficiently established. Moreover, the economy of joint social action in the performance of many services is also thoroughly established. As a result of the payment of taxes, therefore, the people obtain for themselves collectively the benefits and advantages of certain services at less cost than they would otherwise pay, individually, for them.

The taxpayers, in the aggregate, pay for the governmental services. Payment of taxes is burdensome, yet it is the necessary cost of obtaining the public services. As the tax load increases, the disutility of the payments likewise increases. In similar manner, the utility or advantage derived from an expansion of governmental services diminishes as the

amount expended increases, notwithstanding the introduction of new services which should have a higher utility than additional installments of existing services. The approach of the diminishing utility of more services and the increasing disutility or burden of more taxes to a balance should establish a limit to the spending and taxing. The practical difficulty is that two separate groups may be involved. One group may be paying the bulk of the taxes while another may be enjoying the bulk of the benefits. In such a case there may be extremely burdensome taxation of a minority which can never muster sufficient political influence to provide protection, or even an adequate expression of its views.

THE EFFECTS OF TAXATION

That the payment of taxes has its effects, both of a subjective and a pecuniary sort, is generally recognized. Taxes reduce the amount of income which can be spent or saved by the taxpayer. The naive notion that the process of taxing and spending reduces the total amount of spending power in the community will be dealt with presently. Here it is important to note that taxation does diminish the income over which the taxpayer is free to exercise control. It means the substitution of the judgment of others for his own judgment or preferences as to how his income shall be spent. For example, if the effective rate of tax is equal to 20 per cent of income, a person who is paid for working five days, or 40 hours a week, works one day a week for government. Someone else takes and spends his earnings of one work day out each week. If the effective tax rate is 40 per cent, he works two days in each week for government and for the purposes on which government decides to spend his money.

Somewhere up the scale of increased taxation, the taxpayer will conclude that more work in order to gain more income is not worth while. A tax rate far short of 100 per cent will bring him to this conclusion. Since there can be no well-being without the fullest freedom for the operation of all the incentives to produce and to create income, it is essential that the burdens of government be held within strict bounds.

At different times the theory has been advanced that taxation stimulates effort, and various stock illustrations have been accumulated to prove the point.¹ A modern English writer, Dalton, suggests that those who have dependents or who are saving in the hope of securing a fixed income by a certain date, will "feel compelled by the pressure of increased taxation to work harder or to save more."² He thinks that among

¹ Cf. E. R. A. Seligman, *The Shifting and Incidence of Taxation*, pp. 32 ff., for views on the effects of the excise; C. J. Bullock, *Selected Readings in Public Finance*, pp. 222 ff. quotes Hume and McCulloch on the stimulating effects of taxation; C. F. Bastable, *Public Finance*, p. 286 adds the case of the continental taxes on sugar beets.

² H. Dalton, *Public Finance*, p. 107.

those of large means, the placing of obstacles, such as increased taxation, in the way of their desire to go on accumulating, seems only to exhilarate them. Bastable points out that the spur to inventiveness or activity is the prospect of escaping the weight of the tax through some legal or administrative loophole, rather than the certainty of the tax payment. With respect to the motive of reaching a certain financial goal, the effect of definitely increased taxation may be quite similar to that of a definite drop in the interest rate, which may lead the accumulator to decide, as Taussig says, that he, in his old age, or his dependents after him, will simply have to do with less than was originally planned. Increased taxation may lead to a similar decision.

Some shrewd suggestions were made by David Hume, a political philosopher of the eighteenth century, as to the conditions required if there were to be built up the ability to bear increased taxes as they were imposed. These were that the taxes must be moderate, they must be laid on gradually, and they must not affect the necessities of life. He attributed the growth in opulence and industry to the stimulus of the taxes rather than to the productive contribution of the governmental services; but he saw clearly the essential limitation on government's productive contribution, which he stated indirectly as moderate taxation. If government undertakes so much as to require, normally, heavy taxes, Hume would not defend the consequences.

This agrees with what was said above. As long as the governmental expenditure does not extend to a volume that means a sharply diminishing return in economic and social advantages, the taxation to support it may not have decidedly depressing effects, although it is not certain that there will be any widespread exhilaration induced, as Dalton supposes. Bastable emphasizes the opposite of the theory of stimulation or exhilaration when he says: ³

The raising of compulsory revenue means so much loss to the payers and to the community, for which the only return obtained is the benefit resulting from the efficient execution of state functions. Any doctrine that removes attention from this cardinal fact is erroneous in principle, and may lead to serious practical evils.

The effects of taxation will naturally depend on the character of the tax system, that is, upon the characteristics of the taxes levied, on their rates and on the manner of their administration. The subject can best be approached, therefore, from the standpoint of some of the outstanding attributes of taxation method.

Direct and indirect taxation. The accepted distinction between a direct and an indirect tax, as has already been indicated,⁴ is that the former is not ordinarily shifted, while the latter is capable of being

³ *Op. cit.*, pp. 286, 287.

⁴ *Supra*, pp. 255, 256.

shifted, although for various reasons it may not be in particular cases. The distinction is not absolute, but taxes on land, net incomes, estates, polls, and consumption goods such as residences and personal effects, are usually regarded as direct, while business taxes, sales taxes, and commodity taxes generally, are considered to be indirect.

Two effects of direct taxation are thought to be of particular value. One is its tendency to create in the taxpayer a state of mind commonly referred to as "tax consciousness." That is, he is definitely conscious, at every payment, of the fact that he is paying the tax. The other is that it permits a more definite measurement of the actual distribution of tax burdens.

Tax consciousness. The reasons for desiring the citizens to be or to become tax conscious vary. Some groups seek it in the hope that stronger protest may thus be aroused against heavy or unpopular taxes, or against the expenditure program. Others see in it an opportunity of developing greater citizen interest in public affairs, on the theory that as more people become aware that it is their money that is being spent, a more alert and intelligent interest in government will be manifested. This, in turn, will lead to better government.

The existence of tax consciousness, which is a state of mind, is not always easily established; nor is there any assurance as to the reaction to which it may lead, once it is generated. While there is presumption that direct taxes are more likely than indirect taxes to induce tax consciousness, the connection is not inevitable. Direct taxes have not always produced it, or a reaction that would indicate its existence, expressed either as a criticism of expenditure or of general governmental policy. The apathy of property owners to rising local expenditures and taxes is well known, as is their indifference to the sources of governmental waste and inefficiency. If it be contended that part of the property tax may be shifted, and hence is not a burden to the payers, it can be pointed out in reply that home owners have shown no more concern over the situation than landlords. On the other hand, the English excises of the eighteenth century aroused a very active tax consciousness in the people, who hated both the taxes and the unfortunate collectors of them.

Furthermore, the attention of the tax conscious citizen is quite likely to be turned in some other direction than toward the improvement of the governmental organization and processes. Consciousness of the burden of the English excises stimulated evasion, or "bootlegging" as it would now be called. The people of New Jersey were very easily persuaded to demand repeal of the retail sales tax in 1935.

The measurement of tax burdens. The second effect of direct taxation, which is a more definite measurement of the distribution of tax burdens, may be accepted as a desirable objective. This goal cannot be achieved unless the taxes borne by the several taxpayers can be ascer-

tained. While the occurrence of any substantial amount of tax shifting would prevent ascertainment of the total taxes borne by individuals, every extension of direct taxation tends to lessen by so much the area of the field of tax shifting, and hence improves the approximation of burdens.

The case for and against indirect taxation. The chief advantage of indirect taxation is its painlessness. This is commonly considered to be an objectionable characteristic, but in fact it is, in one sense, an administrative advantage. The payment of any tax in dribblets is, for many, an easier way of doing it than by a lump sum at the end of the year. In fact, it may even lessen the burden. Suppose the average cigarette smoker or motorist were required to keep an accurate record of all cigarettes or gasoline consumed during the year and to pay the whole tax on the year's consumption in a lump sum at the end of it. He would protest vigorously, and his objection would probably be based fully as much on the inconvenience of the method as on the amount of the tax. The installment method has become increasingly general with the greater weight of the property, income and estate taxes. Indirect taxes are collected in an indefinite number of small installments, thus carrying a recognized administrative practice to its logical conclusion. Against the fact that the tax bearer does not know how much he is bearing must be set the apparent, and possibly the real diminution of the burden because of the method of payment.

The chief objections to indirect taxation are the converse of the advantages supposed to be offered by direct taxation. The bearer of the tax burden may be unaware of the fact that taxes are being shifted upon him, and since he never sees a tax collector or a tax bill, he may be fatuous enough to suppose that he is paying none. Further, the indirect tax bearer does not know what, or how much, tax he is paying.

Objection is also raised against indirect taxation because of its alleged regressive effect, although this effect is not altogether avoided by direct taxation. The poll tax is regressive, and the property tax is likely to be, not only by reason of the relative underassessment of the larger properties, but also because of the lack of correlation between property ownership and total taxable ability. The severity of the regression in both cases depends on the weight of the tax, but this is a problem for legislators and administrators in the use of both direct and indirect methods.

Finally, the "tax unconsciousness" of the indirect taxpayer may incline him to demand larger expenditures. To this the logical answer is, "Why not?" since he is really paying for them. His failure to realize this fact does not alter it. In view of the steady expansion of governmental services in the direction of greater benefits for the mass of the population, the tendency to pay for these services by taxation methods that fall in some degree upon the beneficiaries of the services is not wholly bad.

Practically, it is the only way by which the program can be financed. The people demand the program, they enjoy its benefits, and by and large, they prefer to finance it by indirect rather than by direct taxation.

The preference for indirect taxation is intuitive rather than rational, yet it is not entirely fair to assume complete ignorance on the part of the people in general concerning the effects of indirect taxation. It would be more nearly correct, probably, to say that the effects are recognized, yet they are preferred, to those of direct taxation.

The effect of the tax rate characteristics. There are two aspects of the tax rate that should be noted. One is the level of rates, the other is the rate structure, which may be proportional or progressive.

The level of rates. Since the level of the tax rates, whether low or high, obviously influences the tax burden, it is clear that one effect of high or of increasing rates is to create more administrative difficulties. These difficulties have to do with evasion when this is possible, or with complaints and suits when evasion is not feasible. The owners of intangible personal property simply got out from under the general property tax as the burden rose. The owners of real property could neither hide their property nor move it, so they had no alternative but to contest the assessments. Income taxpayers have swamped the board of tax appeals, now the tax court, under the stress of high rates.

Heavy rates of taxation may be due to various causes, such as inefficient governmental organization, a narrowly restricted tax system, abnormal expenditures for war or other emergencies, and so on. In general, heavy taxation, expressed through high tax rates, is an indication that something is wrong. If a nation is wealthy enough, it can undertake large expenditures for the general good, yet it should be able to finance them without burdensome taxation. When the program can be provided only by heavy tax rates, it is time to consider whether the expenditure is too liberal, or the frictional losses due to obsolete governmental organization and methods are too great, or the tax load is too heavily concentrated.

- American tax administrators are fond of comparing tax rates in this country with those in other countries, a process which often leads to the conclusion that the rates on incomes, inheritances or other objects may properly be raised here, since they are lower than those imposed elsewhere. The comparison overlooks the long-run effects of heavy taxation on the economic growth of the countries that must impose it, and fails to consider that equally heavy taxation here may have had long-run effects. It is doubtful if any country is levying heavy taxes from choice. As the tax rates increase, the point of diminishing advantage from further government activity is the more quickly reached and passed.

The tax rate structure. The effect of the tax rate structure, whether proportional or progressive, is fairly obvious. Proportional taxation leaves

the taxpayers, after paying the tax, in the same relative position as before, in so far as the relation of the tax to the base is concerned. Progressive taxation, on the other hand, has an obviously leveling effect. The disparity of incomes, estates or of anything else that may be taxed at progressive rates is less after payment of the taxes than it was before, since relatively more has been taken from the large than from the small components of the tax base. In this respect any use of progressive taxation tends toward at least a temporary equalization of wealth or income. That is, at the moment when the taxes are paid, there is some approach to equality. Immediately prior to the next tax payment, the disparity may be as great as ever.

In view of this necessary effect of progressive taxation, advocates of vigorous action by government to secure greater equalization of distribution hold that it may as well be done by taxation as in any other way. In this they are right, since the only impregnable argument for tax progression is its leveling or equalizing effect. But levies openly designed and applied to this end cease to be an exercise of the taxing power and become expropriation, plain and uncamouflaged by any pretense of a public purpose.

The effect of taxing consumption versus accumulation. The two main divisions of the economic process are the production and the consumption of wealth. Economic goods are produced in order to be consumed, but it is evident that there must be production before there can be consumption. Methods of taxation may be classified very roughly, according to whether their weight falls primarily on consumers and on consumers' goods, or on producers, producers' goods and the process of accumulation required to provide more producers' goods, or capital. Such a grouping would necessarily be only approximate, for the ultimate repercussions of any tax may extend to both production and consumption. A rough approximate grouping would be as follows:

1. Taxes falling primarily on consumption:
Commodity taxes, including the tariff and the internal taxes; sales taxes; property taxes on consumers' goods, such as merchandise, residences, and personal effects.
2. Taxes falling primarily on production and accumulation:
Property taxes on capital goods; business taxes; inheritance and estate taxes.

The income tax affects both consumption and accumulation, since under it no allowance is made for personal or family living expenses, nor for savings and investments.

The various ramifications of tax shifting may cause the burden of some taxes to fall elsewhere than in the category in which they are levied. For example, taxes on business or on the capital goods (property) used in business, may be shifted to consumers, or to employees through

lower wages, or to the owners, or to all of these groups in some unpredictable apportionment. Taxes on consumers' goods or on consumption are not ordinarily shifted to producers, but their weight may restrict consumption, and this in turn would restrict production.

Assuming the economic goal of a progressive community to be a steady growth in the capacity to produce *and* to consume, it is apparent that the weight of the tax system should be so distributed as to result in the minimum overall hindrance to the achievement of this goal. It is reasonable to suppose that this minimum interference is more likely to be accomplished, first, by a distribution of taxation over both consumption and production rather than by a concentration upon either aspect alone, and second, by the avoidance of excessive taxation.

The burden of taxation is always a relative matter, and no one can say, for any given economic society, when it has passed from the moderate to the excessive stage. Certainly all taxes are now imposed at heavier rates than were levied a generation ago, and the available evidence as to the growth of the national wealth and income indicates that much larger proportions thereof are being taken now than were formerly taken. It would be difficult to produce convincing evidence, in face of these facts, to show that the existing volume of governmental services is of such definite and positive advantage to the productive processes as to counter-balance the deterring effects of the tax drain. Until this proof is forthcoming, it would appear that governmental costs are now too great, that there has been a sharply diminishing return from the later installments of governmental service, and that a substantial reduction of governmental costs, and thus of taxation, would release and stimulate both producing and consuming capacity. The advance of the general standard of living depends on greater production and consumption.

In conclusion, it appears that excessive taxation of either consumption or of production and accumulation would be injurious. In view of this conclusion it appears that there should be greater recognition than is given to a needed limitation on the theory of ability, whether it be on the mass ability of the population to bear consumption taxes, or the ability of those who control large incomes or estates. Much of the emphasis that has been placed on "ability" as a rule or criterion of taxation has been without consideration of the effects of taxation so devised on the flow of investment funds. As pointed out above, while the entire capital fund is not provided by those with large incomes or accumulations, it is provided by the whole group of savers, and it is easy to neglect the significance of the services of this group when following too keenly the scent of ability taxation. Nothing is clearer than that the capital fund losses caused by severe taxation of incomes and estates will not be made up by savings contributed by the consuming or "non-saving" group.

It is often urged that heavy estate taxation does not diminish capital,

and this is true, in the sense that it does not diminish the country's stock of machinery, ships, factories and other tangible apparatus of production in existence at the time the tax is levied. But the stock of capital goods at any one time is not permanent wealth. It is being constantly used up, and as constantly replaced. Further, the total stock must be added to if there is to be greater aggregate production and a higher standard of living for all. The effect on the existing stock of capital goods is not the significant test of the ultimate influence of such a tax. Rather, it is the effect of the tax on the maintenance and increase of the stock that must be considered.⁵ Prolonged, heavy death taxes will no doubt check the growth of the capital supply from its present sources. It is possible that the loss could be made up in some other way, but no provision for doing this has accompanied the sharp increases in death tax rates.

A similar consideration applies to inordinate taxation of incomes. So far as the income actually received goes, the ability to pay as much, or more than has been levied, is there. Moreover, the taking of large slices of net incomes may not immediately affect contemporary production adversely. But the diversion of large amounts of personal income from its normal destination as a source of capital funds will inevitably diminish the future increases of capital from this source, and no provision has been made, under any income tax or any fiscal program, for making good this loss in any other way.

The services of those who, from small and large incomes, have created the country's capital supply are easily overlooked or deprecated. Indeed, there is apparently a belief held by many persons to the effect that this is no service at all, which implies that capital creation is virtually a spontaneous affair. Such persons should consider the case of various countries that have ample natural resources and a virile population, but little capital, in order to appreciate what is involved in providing and increasing this essential to efficient production.

It may be contended that the public expenditures create capital, and that in the aggregate the supply is maintained or increased, the only difference being the different form or direction of the public, as against the private, investment. This is a conjectural, and hence a controversial point. Some part of the government's expenditure may result in capital formation, although the proportion so resulting, as against that part which results in increasing the demand for consumers' goods is small enough to be negligible. In any event, additions to the effective capital fund that may result from the character of government spending are largely fortuitous. Only a naive faith in the miraculous would persuade

⁵ Cf. G. E. Hoover, "The Economic Effects of Inheritance Taxes," *Amer. Econ. Rev.*, Vol. XVII, pp. 38-49 (March, 1927). See also P. Hansel, "The Proper Sphere of Death Taxes," *Annals of the American Academy of Political and Social Science*, Vol. 183, pp. 86-95 (January, 1936).

the people that the country's capital fund can be sustained by the casual and accidental fruits of the ordinary public expenditure program.

The whole subject of the effects of taxation may be summed up in Chief Justice Marshall's famous dictum: "The power to tax involves the power to destroy." There being no restraint on the taxing power except that which government itself imposes, it is incumbent upon government to use this power with discretion. No governmental program can be important enough to justify, in its support, the destruction of the ability of the people to produce and consume. In doing this, government destroys not only the people, but itself. Professor H. C. Adams suggested as one of the axiomatic truths of the science of finance the following: "*A sound financial policy will preserve the patrimony of the State.*"⁶

His explanation of what constitutes the patrimony of the state may fittingly serve as a finale to this part of the discussion:

In modern times and among peoples who practice the law of private property and the theory of individual rights, the patrimony of the State consists in a flourishing condition of private industries. Public revenue is not secured to any great extent from the ownership and direct management of productive property, but from taxes levied upon industries the property of citizens. The more flourishing these industries, the larger is the fund to which the State may appeal for public revenue, and on this account it should be the prime consideration of the financier that nothing shall be done which will in any way impair the efficiency of private industry. A sound policy of public finance must rest upon a thorough knowledge of political economy.

TAXATION AND THE PRICE LEVEL⁷

The doctrine that taxing, spending and borrowing should be used to influence the economy rather than to promote the prudent management of the government is a product of recent theories about fiscal policy. The purpose of fiscal policy, according to this view, is said to be the maintenance of national income and employment; but in reality it is the maintenance of a steady and continuous inflation which the devotees of the planned economy so often mistake for prosperity.

A major tenet of the new fiscal doctrine is that taxation affects the price level. It is asserted that taxation, and particularly some kinds of taxes, have a deflationary effect. Judgments regarding the volume of taxes to be collected, or the kinds of taxes to be used, are based on dogmatic pronouncements about deflation. Curiously enough, there are others who invoke, as an argument against some kinds of taxes, the assertion that they are inflationary.

In discussions of this sort the terms *deflation* and *inflation* are freely

⁶ H. C. Adams, *The Science of Finance*, p. 4.

⁷ The remainder of this chapter has already appeared under the caption, "The Effects of Taxation," in *The Tax Review*, Vol. VI, No. 4, April, 1945. Published by The Tax Foundation, N. Y. By permission.

used without definition. They have become household words generally used to frighten people. In the current fiscal demonology, anything that is either inflationary or deflationary is bad. Hence, to attach either label to a tax serves, for many, as a powerful argument against it.

In a technical sense inflation and deflation refer to changes in the volume of bank credits. The dictionary definition of the verb *inflate* is helpful here. It is "to swell or distend with air or gas." The definition is peculiarly appropriate in the case of credit expansion through public loans. Popular usage of the terms *inflation* and *deflation* deals rather with the results of credit inflation and deflation in terms of price changes. Price is the monetary expression of the relation between purchasing power and goods. Bank deposit credits are the principal form of purchasing power. Hence changes in the amount of bank credit affect the volume of purchasing power. In general, and without regard to various qualifications, it can be said that when total purchasing power increases faster than the total of goods, prices rise. On the other hand, if total purchasing power diminishes, or increases less rapidly than the total of goods, prices fall. Whether inflation should describe any price rise or only a relatively severe one, is a matter on which the experts are not in full accord. The same questions would arise and the same lack of accord would be evident regarding the use of the term *deflation* in the case of a price decline.

Those who prefer to estimate the effects of taxation primarily in terms of its influence upon the price level are entirely indefinite, but they would probably want to use the terms *inflation* and *deflation* to describe moderate degrees of price change up or down, respectively. Obviously, they would then have a much better basis for their case than would be available if these terms meant a rampaging, runaway price change up or down as the case may be. But when there is only a slight movement of prices in either direction, it becomes much more difficult to identify with precision the factors and influences that may be responsible therefor at any given time. Proof that taxation had anything to do with the change becomes correspondingly more difficult to establish.

More serious difficulties are involved, however, in the theory that taxation in general, or specific kinds of taxes in particular, can have appreciable effects on the price level. The contention that taxation is deflationary is more frequently advanced than that its effect is inflationary. Moreover, the whole case for any effects of either sort has been built up under the régime of deficit financing. Such validity as the deflationary argument may possess exists only under a deficit policy; but even so, the connection between taxation and the price level is only indirect.

The reasoning of those who believe in the deflationary effect of taxation is about as follows: Taxation deprives the taxpayers of money that would otherwise be spent for goods and services. This causes a decline in

the total purchasing power available for such expenditures and thus leads to a fall in prices. Hence, taxation is deflationary.

The foregoing summary of the case is somewhat conjectural, for those who assert a deflationary effect for taxation have never troubled to set out the successive steps by which the conclusion is reached. The gaps in the logic are obvious. If the government is spending in excess of its current tax revenues, it is evidently meeting the remainder of the outgo, above taxes, by borrowing. Normally, a part, if not all of this borrowing is done through the banks. The creation of bank deposit credits through sales of bonds to the banks is the real source of any inflationary tendency that may be manifest. Under such conditions an increase of taxation which would reduce the size of the deficit would correspondingly lessen the amount of the borrowing. It would diminish by so much the inflation of credit and the result would be, by comparison, deflationary. This result would follow indirectly rather than directly from the tax increase, for the levy of additional taxes, per se, would cause no change of overall purchasing power in either direction. Being on a deficit basis, the government would spend promptly all that was taken from the taxpayers. The payment of taxes and the spending of receipts would occur simultaneously and continuously and the overall relationship between purchasing power and goods would not be affected by the taxing process.

Thus it appears that the real reason for such deflationary effects as may be produced by taxation is not to be found in any direct influence of the tax payment process upon the price level, but in the fact that the use of taxes in lieu of loans renders the true cause of the inflation less potent. Any kind of taxation would serve as well as any other kind to reduce the deficit, and hence all kinds of taxation would be equally deflationary under these conditions.

If it be assumed that the budget is balanced, then it becomes erroneous to impute effects on the price level to any kind of tax. From the standpoint of the mechanics of the process, taxation is merely a transfer of income or purchasing power from the citizens to the government. Each taxpayer can spend less for goods and services by the amount of his tax. This fact would be capable of causing a decline of the price level through a diminution of purchasing power only if it were true that the taxes disappeared into the Treasury, never to be seen or felt again in the income stream. But this is not the case. The money goes in through one door and promptly goes out again through another. To the extent that the government might be accumulating a huge general fund balance it could be true that more had gone in than had come out. Ordinarily there is no piling up of a vast idle hoard in the general fund.

At this point the argument that taxation is deflationary is apt to take a new turn, in that it becomes an argument for or against certain kinds

of taxes. For example, it is said that steeply progressive income taxes may be inflationary because they are a means of transferring income or purchasing power, through the taxing and spending procedures, from those who are disposed to save and invest to those who are disposed to spend. This equalization of purchasing power tends to increase the demand for goods, and prices may advance under the stimulus of the greater demand.

It is to be noted that this logic fully recognizes the transfer character of the taxing process by conceding that what goes in comes out again. It fails, however, to recognize that the act of saving and investing is simply a different form of spending from that involved in retail shopping. But saving and investing lead to an increase of retail shopping somewhere, for the purpose of investment is to enlarge the capital fund, which means that jobs are created, wages are paid for productive effort, and well-being is enhanced. The outcome is that the volume of production, income and consumption is likely to be greater without, than with, the kind of arbitrary transfer that is involved in a steeply progressive income tax.

The opposition to excise and sales taxes has relied strongly on the supposed deflationary effect of such taxes. Here the transfer aspect of taxation, which is deemed to operate so well in the case of progressive income taxes, appears to get lost in the shuffle. The deprivation of purchasing power is played up heavily.

Illustrative of the line of argument commonly used is the following passage:⁸

A sales tax generally tends to be deflationary and, therefore, harmful in periods of low consumer spending. On the other hand, in boom periods, when deflationary pressure may be needed, such pressure may be achieved by promptly adjusting income tax rates. It must be pointed out, however, that if deflationary measures are needed, higher income taxes in the brackets where the spending comes will have to be accepted. If such measures are not adopted, then a deflationary sales tax may be inescapable.

The reader should be able readily enough to spot the flaws in this statement. The principal one is the omission of any reference to the budget, yet the whole force of the argument turns on this point. Failure to specify whether or not the budget is assumed to be balanced compels the passage to be interpreted to mean that a sales tax would be deflationary in a depression although income and other taxes would not be; and that both income and sales taxes would be deflationary in a boom period. It cannot be too often repeated that any characterization of taxation as deflationary or the reverse is meaningless unless the assumption that is made about the budget be clearly stated.

The following illustration may serve to clarify this point. Suppose that the budget is balanced at \$15 billion and that this amount of revenue

⁸ *Fiscal and Monetary Policy*, by Beardsley Ruml and H. Chr. Sonne, National Planning Association, July 1944, p. 12.

is obtained as follows—\$11 billion from individual income tax and \$4 billion from other sources. If the tax system were recast to produce \$9 billion from the individual income tax, \$2 billion from a sales tax and \$4 billion from other sources, it would be difficult to establish that the shift would depress the price level.

In the first place, the sales tax revenue of \$2 billion is counterbalanced by the reduction of income tax in a similar amount. As the passage quoted above points out, the bulk of the income tax, like the bulk of the sales tax, would come from the income brackets where the income is, namely the lower brackets. The bulk of the income tax reduction would likewise occur here. Although some persons not liable for income tax would pay sales tax, the reduction of buying power in such cases would be offset by the remission of income tax to a vast group of other persons.

In the second place, the transfer process makes it clear that the entire \$15 billion of taxes would be returned to the income stream about as rapidly as it was collected. This would occur by the payment of salaries to public employees, of aids and grants to federal beneficiaries, of settlements with contractors who must meet payrolls and bills for materials and supplies (which means other payrolls somewhere) and interest on the public debt. The reduction of taxpayer income and buying power through payment of taxes is offset by providing others with income and buying power through the public spending.

It is sometimes asserted that the deflationary effects of taxation are most likely to be apparent when taxes are being collected in an amount sufficient to provide for some debt repayment. The following passage reflects this idea: ⁹

Retaining high taxes on the masses of consumers for general reduction of debt held by financial institutions may destroy purchasing power and create unemployment. But the use of progressive taxes for the redemption of bonds held by millions of individual savers may have a stabilizing influence on incomes and employment.

The first proposition set out here is that it might destroy purchasing power and create unemployment if the tax system were relying liberally on excises, low bracket income taxes and sales taxes while the debt which was being retired was that held by banks. The implication is that money used for such debt redemption disappears into the banks for good.

The disposition of debt payment proceeds by the banks will depend on bank policy. Banks require adequate reserves. They would seek extreme liquidity and large excess reserves only in contemplation of highly uncertain business prospects. The redemption of debt, and particularly the reduction of the floating debt held by them, could augur, for them and for business generally, a policy of fiscal and monetary stability that

⁹ *Budget Message of the President for the Fiscal Year 1946*, p. XIX.

might promote more employment and the creation of more income than would be created by remission of excise and low bracket income taxes. This would be the more likely if the price of that remission were to be a dangerous floating debt, further dilution of bank reserves and a threat of additional currency devaluation.

The second proposition in the above passage from the budget message is that the use of steeply progressive taxes to redeem bonds held by millions of individual savers may have a stabilizing influence on incomes and employment. This is another version of the argument dealt with above. In addition to what was said there, it may be noted: First, there is an assumption that all holders of Series *E* bonds will spend the full redemption value thereof on receipt instead of reinvesting part or all of it; second, a steeply progressive surtax alone would not produce enough to permit much redemption, and if a high normal tax were used, the Series *E* bondholders would contribute substantially to the redemption fund.

If there are good reasons why excise and sales taxes should not be used, they must be sought elsewhere. The resort to price and monetary theory as a basis for deciding whether or not to tax, and for judging among different kinds of taxes is bad economic logic and quite misleading as a guide to policy. It is a natural consequence, however, of the notion that government should use its fiscal powers to produce results that the planners have set up as the national goals.

If the position taken here be correct, the only important direct source of government's ability to produce those results for the economy in which the fiscal medicine men are most interested is the public credit. By resort to bank loans on a sufficient scale it is possible to inflate the price level and the so-called national income. And by varying the amount of taxes the inflationary pressure to higher prices that is generated by the borrowing can be decreased or augmented. As long as the budget is in balance the processes of taxing and spending are practically neutral so far as concerns the price level and the income level. It is not without significance that the advocates of government control through fiscal policy have an aversion to a balanced budget akin to that which his Satanic majesty is said to have for holy water. Their schemes would not work while the budget is in balance. Fiscal policy, for them, is debt policy and the ends which they seek are attainable only through a continuous expansion of the public debt.

Another aspect of the proposition that taxation tends to cause price changes involves the theory and practice of tax shifting. This is quite a different matter from an inflationary or deflationary result as reflected in price level changes. It proceeds from the accepted accounting practice of regarding all taxes paid as expense and therefore as items which enter into the cost of production. The effort of every one in business is to

obtain a price that will afford a profit, and which will provide at least, for a recovery of costs.

Making the effort to recover costs is not the same thing as actually recovering them out of receipts, as every business man knows. The record of business failures and of no-profit income tax reports shows that many thousands of business concerns do not succeed in doing this in any given year. The theory and logic of tax shifting indicate that *in the long run* taxes which burden capital or the income from capital will be shifted, for the reason that an inadequate return will cause the supply of capital funds to decline and production to fall off, thus ultimately bringing about a price for goods that will provide the necessary net return after taxes. This does not mean that every business concern, or even a considerable number of concerns, regularly and consistently succeed in shifting their taxes, including income taxes on net profits, through higher prices.

In the publication quoted above, Messrs. Ruml and Sonne reflect a typical business point of view in saying that the federal corporation income tax tends to raise the cost of goods and services and in some cases to pyramid it. The caution displayed in stating the matter as a tendency rather than as a demonstrable fact is commendable, although elsewhere in the same publication it is suggested that one result of exempting corporations from income tax might be lower prices for corporate products. This could hardly be the case except in those instances in which the corporation tax is a cause of higher prices. Neither side of this question is demonstrable.

There is no intention here to deny that taxation has its effects. This would be peculiarly gratuitous in the face of the evidence on every hand of its destructive effects. The position upheld here is that these effects are not to be looked for in the realm of price level changes.

An illustration of the destructive effect is provided by the proposal to exempt corporations from income tax. This plan involves, as a corollary, higher individual income taxes. There are several million sole proprietors and partnerships engaged in business, and under the law as it has stood since 1913, income tax must be paid on the entire business income, whether distributed or not. An increase of individual income taxes would fall upon all business earnings of unincorporated concerns. Assuming that such concerns also shift their income taxes on business profits—and they should be able to do this if the corporations can do it—then the higher personal taxes on such business income would compel them to make extraordinary efforts to shift the increase through higher prices while their corporate competitors were reducing prices after tax exemption. It is no answer to say that all unincorporated business could gain the exemption at the nominal price of a corporation charter. That so many of them have not done this suggests a preference otherwise for what are apparently deemed good reasons. This freedom of choice of the form

of business organization would be destroyed, yet unincorporated business would suffer seriously from the discrimination unless it accepted the corporate form.

A proposition that is not likely to be disputed is that taxation is burdensome at all times and under all circumstances. The obligation to pay taxes, as a way of defraying the cost of governmental services, is generally recognized; but this realization does not obliterate the disagreeable aspect.

We have here a clue to the reason why expenditures and taxes should not be too large, although it would appear, from the emphasis upon the transfer character of taxation, that the budget could as well be \$25 billion or \$30 billion as \$15 billion. The real reason for moderation in the budget is that, since taxation is disagreeable and burdensome, it produces bad effects upon the taxpayers, effects that are in no way offset by the fact that the money taken from them is turned over promptly to someone else to spend.

Two lines of influence upon the taxpayer are evident. He has less money, by reason of his taxes, to be applied to other things; his economic motives and incentives are involved as well as his pocketbook. Primarily, the depth of the effect on incentives is influenced, and it may be governed, by the size of the exaction. There have been cases, however, in which a moderate tax has excited extraordinary popular resentment.

Economic effort is inspired, in some degree, by non-pecuniary motivation, yet by and large the economic motive is dominant. Most people exert themselves more if the prospective reward is greater in tangible economic terms, that is, in profit or wages or some other form of income. Taxation reduces these rewards. It imposes on us a kind of compulsory altruism, whereby we spend a part of our time in working for others. When one is compelled to spend more of his time or to devote more of the fruits of his ability to this kind of altruism than he feels is proper, his normal corrective procedure is to obtain relief by doing less. This is, for the individual, a more speedy and more effective remedy for excessive taxation than to undertake, through group action, to secure those economies of government which would reduce the tax levies. Such reaction is more likely to occur under the ordinary routine conditions of peace than it is under the stress of some great national emergency such as a war.

The injurious effects of taxation on individual motivation occur at points where they are least likely to be readily perceived, although at the same time they are most likely to cause maximum damage. Most of us must learn to adjust our necks to the tax yoke, be it heavy or light. We have neither the opportunity nor responsibility for making decisions on which the jobs and the well-being of others depend. Among all of the economic decisions, none is more significant for the general well-being than the decision whether or not to save and invest, to risk capital, to

venture into a line of business where great rewards or great losses may lie ahead. In short, the greatest damage of severe taxation is done by tax rates and tax methods which impair the vigorous functioning of the enterprise system. The chief concern of legislators and of tax students should be with the effect of taxation on enterprise, rather than with such esoteric matters as its effect on the price level.

PART IV

Public Credit

CHAPTER XXX

The Nature and Principles of Public Credit

THIS SECTION of the book deals with public credit. It is, in one sense, a continuation of the subject of public revenue, begun in Part III; since public borrowing provides expendable resources, and the chief reason for resorting to public loans is to obtain additional funds more easily than they could be secured through heavier taxes or higher charges for administrative services. As will be seen, there is more to the process than mere borrowing. A properly rounded knowledge of public credit involves understanding of its nature and principles, and of the administration of public debts. These matters are dealt with in this and the following chapters. Separate chapters are then devoted to federal, and to state and local debts, respectively; and in a final chapter some of the effects of public borrowing are discussed. Before proceeding with the exposition of the nature and principles of public credit, its development requires brief notice.

THE DEVELOPMENT OF PUBLIC CREDIT

The institution of credit has been known to the economic world for a long time, and its use by rulers goes far back into the past. Dionysius of Syracuse borrowed from the citizens, and then debased the currency to repay the loan.¹ It would be improper to regard this and other, later instances of borrowing by princes and rulers as illustrations of public credit. Rather, they were transactions involving the personal credit of the sovereign. Public credit, which means a pledging of the good faith and the resources of the whole people for the repayment of a debt incurred on their behalf, could not emerge until certain other definite developments had occurred.

Constitutional government. One of these developments was the growth of constitutionalism, whereby the people gained some degree of control over the public purse. Only then, when the people could approve of the taxes, and thus presumably of the purposes for which they were levied, could it be said that the public had begun to borrow on its credit.

¹ C. J. Bullock, "Dionysius of Syracuse—Financier," *The Classical Journal*, Vol. XXV, January, 1930, pp. 260-276.

The rise of public credit is therefore contemporaneous with modern constitutionalism. It is significant that the English public debt was not initiated until after the Bill of Rights had provided popular control over taxation. Bastable mentions the Russian imperial debt as an instance of the creation of a public debt antecedent to the establishment of constitutional government, although he admits the validity of the general proposition. But the present Russian government rejected this debt as an obligation of the Russian people, on the ground that they had no voice in its creation.

A general money market. The extensive development of public borrowing also depends upon the existence of an economic surplus that can be absorbed by the borrowing government. This involves, as Adams points out, the existence of a money market, in which there is a certain amount of liquid capital funds seeking investment. It presupposes, also, a certain advance in commercial ideas and practices, such as had come in the Italian cities by the twelfth and thirteenth centuries, and in Holland by the seventeenth century. In both Italy and Holland, banks were established as a means of furthering public credit operations, but in each instance there was a close relation between the administration of the government, the creditors, and—in the case of Holland—the leading commercial activity. The commissioners who managed the Bank of Amsterdam were members of the city government, and the Dutch East India Company, one of the principal borrowers, was very close to the management of both city and bank.²

Public credit and democracy. More than a half-century ago, Professor H. C. Adams asserted that public borrowing was inimical to the full realization of self-government.³ His argument ran as follows:

As self-government was secured through a struggle for mastery over the public purse, so must it be maintained through the exercise by the people of complete control over public expenditure.... Any method of procedure, therefore, by which a public servant can veil the true meaning of his acts, or which allows the government to enter upon any great enterprise without bringing the fact fairly to the knowledge of the public, must work against the realization of the constitutional idea. This is exactly the state of affairs introduced by a free use of public credit. Under ordinary circumstances, popular attention can not be drawn to public acts, except they touch the pocket of the voters through an increase of taxes; and it follows that a government whose expenditures are met by resort to loans may, for a time, administer affairs independently of those who must finally settle the account.

At the time this was written, there were two conspicuous illustrations. One was in municipal finance, the abuses of which led Adams to say that every rule laid down by finance had been disregarded. The other was the

² C. F. Dunbar, *Chapters on the Theory and History of Banking* (1906), Ch. VIII.

³ H. C. Adams, *Public Debts* (1887), pp. 22, 23.

small weak state that had lost such semblance of political independence as it might have had through unwise foreign borrowing. To some extent this was inevitable, as the great industrial nations reached out for supplies of natural resources, and for land into which to pour their surplus population. The native states along the south shore of the Mediterranean were taken over, but their foreign loans provided an excuse rather than a reason. The political situation in eastern Europe was long complicated by the large French and English investments in the Ottoman debt, and by the obstructive tactics of these creditors. There has been a considerable degree of foreign interference in the affairs of various central and south American states in the interests of foreign creditors.

It is fair to consider whether the lavish use of public credit by the federal government during the depression decade of the 1930's provided a further illustration of the significant proposition laid down by Adams. Credit was freely, even wastefully, used in that period and there was no disposition on the part of Congress to consider carefully the purposes to which the funds so obtained were to be devoted. The federal debt was more than doubled in the decade 1930-39. While the ostensible purposes were provision of relief and promotion of economic recovery, the real significance of the borrowing program lay in the fact that, as Adams has put it, public servants were able to veil the true meaning of their acts and they were able to embark upon great enterprises, including vast and ambitious schemes of social reform, without having to touch the pockets of the voters through taxes. During this period the doctrine emerged that the manipulation of public credit was a proper and necessary application of fiscal policy and that no harm could be done by an indefinite expansion of debt. This is equivalent to saying that no harm can be done to the democratic system by permitting the government indefinitely to administer affairs independently of those who must finally settle the account.

By no stretch of the imagination is it conceivable that the American people would have sanctioned the spending of the thirties had it been financed through taxation. Public credit prevented the maintenance of that scrutiny of expenditures which is essential to popular control over the purse. There was, therefore, a surrender of some part or element of that control, and to that degree a failure during these years to realize complete self-government.

THE NATURE OF PUBLIC CREDIT

Although there is no mystery about credit, yet it is not generally understood. On the contrary, there is widespread misunderstanding as to its nature and the limitations on its use. In consequence, there have been serious abuses of credit, and much wasteful expenditure that would

not have been made had public credit been better understood, or had it not been available.

Public credit is a branch or form of credit in general, and as such it is subject to the rules and principles that govern the use of all credit. Fundamentally, *credit means a promise to pay in some form or other*. It represents the present delivery of something of value in exchange for a promise to pay at a later time. This promise to pay ordinarily relates to the payment of money, although it is conceivable that a credit instrument could be created that would rest upon a promise to pay in some commodity other than money.

The basis of credit is trust, confidence, faith in the ability and the good intentions of the other party to a loan or credit transaction. A great range of credit instruments has been developed to meet the varying needs of ordinary private credit operations. Examples of these are the note, the draft, the bill, the check, the letter of credit and the bond. In some way or other, all of these instruments involve the immediate use of or control over purchasing power in exchange for a promise to repay or make good the amount so used. The check and the sight draft are simply orders to transfer immediately credits already existing, but they, too, rest ultimately upon the same basis as other credit instruments. Sometimes the use of these instruments of credit involves the provision of collateral security, which usually consists of some kind of property for which a ready market exists. In the event of default, the creditor may recover his principal by selling the collateral.

Public credit, by which is meant the use of credit by the state or some subdivision thereof, is the promise of the borrowing unit of government to pay money or some other thing of value. In modern times these public promises are always expressed in terms of money, for the state always finds it most convenient to acquire general purchasing power by means of which to secure the materials and services required by the character of the emergency. Modern public loans are always made, therefore, in terms of money. The normal basis of public credit is the trust and confidence which public creditors have in the ability and the intention of the debtor state to pay interest and principal when due. Public and private credit are alike in that they both depend upon the resources of the debtor, the promptness and certainty with which obligations are discharged, and a reputation that is free from any taint or suspicion of default, intentional or otherwise.

Credit is a secondary source of revenue. If the pledges relating to repayment which are made when credit is used are to be taken seriously, then credit must be regarded by the state, as by the individual, as a secondary source of purchasing power. In this respect all credit is a mortgage or lien against future income, and its outstanding amount must be kept in such relation to that future income as to assure repayment

without undue impairment of the capacity to meet the ordinary current requirements of the future. Over-borrowing against future income means perpetual indebtedness and eventual bankruptcy.

From this standpoint, credit must necessarily be a secondary source of funds. But this is an old-fashioned viewpoint according to those who have accepted and are exploiting the doctrine that public debt need not be repaid, except as convenient, which usually means never. Under this doctrine debt can be the means of creating larger future income. By selling government bonds to the banks, additional purchasing power is created without depriving the citizens of any part of their own respective incomes. Thus the total national income, as expressed in dollars, is raised. If the troublesome matter of redeeming these bonds be dispensed with, the only burden involved in the increased debt is the taxation to pay the interest thereon. And if, by creating enough purchasing power through the medium of bank loans, the national income is inflated to a high level, the taxes for interest payments might not be too burdensome.⁴

Obviously, the way to escape even the taxes for interest would be to force the banks to accept non-interest-bearing government bonds. A still simpler way would be to compel the people to accept non-interest-bearing government notes or promises to pay. A small amount of such notes exists today. They are called "Greenbacks." The inflationary effects of bonds stuffed into the banks is no different from the effects of using Greenbacks. Every one would perceive at once the fallacy of raising incomes and getting rich by using Greenbacks. Yet few appear to be concerned over the methods which have been actually used and defended to achieve the same result, namely the translation of government bonds into purchasing power through the medium of bank deposit credits.

The failure of current revenues to cover the expenditures of any fiscal period results in what is known, both in popular usage and in strict accounting practice, as a *deficit*. Such a situation may be due to a variety of causes, or to a combination of circumstances, such as unforeseen shrinkage in income resulting from business depression or from foreign or domestic disturbance which interrupts the flow of public or private income. It may be due to unusual expenditure, occasioned by some emergency such as war, or a disaster such as flood, fire, or earthquake. Again, the unusual outlay may be necessitated by the erection of public buildings or the investment of large sums in enterprises that may yield a return

⁴ This view is expressed in the budget message of January 3, 1941, p. xiii, as follows:

"I understand the concern of those who are disturbed by the growth of the federal debt. Yet the main fiscal problem is not the rise of the debt, but the rise of debt charges in relation to the development of our resources.

"The fight for recovery raised national income by more than 30 billion dollars above the depression depth. In the same period the total annual Federal interest charges increased by 400 million dollars. Even if these interest charges increase, they can scarcely present a serious fiscal problem so long as a high level of national income can be maintained."

in time, but which require a heavy capital outlay at the start. Finally, the deficiency may be due simply to carelessness in the rate of expenditure and the failure to observe ordinary prudence in the management of financial affairs.

At all of these points there is a strong resemblance between the public and the private economy. Neither the government nor the individual can spend more than has come in, and the appearance of a deficit in either case compels resort to other devices for making ends meet. The possible choices for balancing income and outgo are much the same for the government and the individual.

In the first place, both the individual and the government may reduce expenses. Under certain circumstances the former may drastically curtail his scale of living and thus avoid the actual fact of a deficit, or at least mitigate its consequences. Likewise, some governmental activities may be discontinued or suspended when the appropriation for the year is consumed before the end of the year. It is not always possible for the individual suddenly to stop or reduce his spending, but it is even less easy for government to put on the brakes. Governmental needs are less flexible than those of the individual, and aside from scattered instances of drastic reductions in minor activities, which are usually made for display purposes, the scale of governmental operations must continue until abated by efficient reorganization of public functions and administration. The sporadic public economies that are achieved by "window dressing" methods for campaign purposes are of little significance in reducing, permanently, the cost of government.

The failure to reduce expenditures sufficiently to ward off a deficit leads, in both public and private economy, to a selection among three choices. One of these is to fall back on some reserve fund or accumulation of wealth which may be spent to cover the excess of expenditure requirements. A second is to increase current income, and a third is to make use of credit. From the standpoint of the government these choices mean either the use of whatever treasury hoard or surplus may have been accumulated for the purpose, or an increase of taxation, or a resort to public borrowing. Both the individual and the government may postpone payment of obligations until after the close of the fiscal period, but this is simply the use of credit in another form. The former will have an accumulation of unpaid bills, which means that he is making use of mercantile credit, since the dealers and others who have supplied him with goods and services are carrying his charge accounts. The latter will have unredeemed warrants or promissory notes outstanding, or it will compel its creditors to carry book accounts and claims until revenue collections are made.

The use of accumulated reserves to cover emergency expenses would be satisfactory enough, provided a reserve of wealth were at hand, and

in such form as might be readily converted into general purchasing power. Its accumulation by government means a previous period of surplus revenues, or the possession of public property for which a market exists. If the treasury department has been able to ward off the attempt at spending the surplus as it appeared, and has been sufficiently honest and competent to keep the accumulation for future emergency uses, the precise form in which to carry it has perplexed those writers who have favored the policy. A specie hoard imposes a severe burden on the community which is thus deprived of the use of the metal in trade and banking, while it suffers from the alternate withdrawal from and return to circulation. In addition, there is loss of interest. If the reserve be kept in securities or land, the emergency that compelled resort to this resource would probably have paralyzed the markets in which the property could be sold. During ancient and medieval times the hoard of treasure was a characteristic resource for meeting both current and abnormal expenditures. It has been generally abandoned in modern times, although the German Empire carried until 1914 a small gold fund earmarked for war purposes, in a fortress at Spandau. The sum thus designated (120,000,000 gold marks) was too small to be of practical importance in financing modern war operations, and its chief effect was to contribute in Germany to that feeling of preparedness and national security which helped bring on the first World War. In other words, it was just large enough to have a mischievous effect.

The second alternative remedy is to increase the income from current sources. This readjustment must eventually be made, and the regular appearance of a deficit is the signal for revision of the revenue system. But immediate readjustment is not always feasible, although it is more easily accomplished in public than in private finance. The individual whose outgo is exceeding his income may be goaded thereby to greater exertion, and he may succeed in securing the additional income necessary to meet his heavier expenses. Ordinarily, however, private incomes are not sufficiently flexible to permit of immediate adjustment by expansion. Governments may accomplish this through the exercise of the sovereign power of taxation. Nevertheless, the sudden increase of taxes, especially during an emergency, may be undesirable or even impossible. New taxes are not worked out in a day, and when adopted they achieve maximum productivity only after some lapse of time. The heavy increase of old taxes may mean that the burden of the emergency expenditure is laid upon those reached by the existing taxes, whereas the cause of the deficit may have been such as to render wider diffusion of the burden proper and desirable. Thus, the heavy cost of a war of defense should possibly be more widely and equitably distributed among the citizens than the existing tax structure at the outbreak of the war will permit.

It is possible, also, that the tax burden is already so great as to make

further heavy increases inadvisable. An emergency usually demands that the productive capacity of the people be maintained or increased, and the retarding effect of additional taxes must be taken into account in seeking readjustment of the finances by increase of taxation. If the increased expenditure is for public buildings, public works or permanent improvements of any sort, there will ordinarily be strong sentiment against severe taxation for the outright financing of such projects. In the case of local governments, too, restrictions on the kinds of taxes, the rates, or the amounts of levy, frequently prevent resort to this means of meeting extraordinary requirements. The history of American local finance furnishes many instances in which such restrictions have prevented cities and other local units from levying taxes sufficient even to meet the ordinary current expenditures.

THE PRINCIPLES OF PUBLIC CREDIT

Since public credit is simply the use by government of a device known and used throughout the commercial world, the principles underlying government credit are not different from those that apply generally. The similarities and contrasts that have just been noted between the state and the individual as debtors do not reveal any important differences between public and private borrowing. In both cases the credit rating will depend on much the same factors.

The factors that determine the ability of the individual to obtain credit are sometimes represented as the three "C's"—Character, Capacity and Capital. Lenders do not always insist that the borrower have capital, or collateral resources, but when this lack is overlooked, it is because of their extraordinary confidence in the borrower's integrity and in his capacity, which includes judgment regarding the selection of an enterprise as well as managerial ability. In the case of a government, character means the sense of honorable obligation on the part of the whole people with respect to meeting the terms of the debt contract. Capacity means the good judgment of the administrative officers in determining wisely the purposes for which borrowing should be used and in discriminating between the proper and the improper uses of public credit. For the capital requirement of the individual debtor should be substituted the resources of the state, which are, ultimately, the wealth and taxable capacity of the people.

Character. The first underlying essential of credit is character. In practical application it involves certain questions, which the lender must always consider: Is the borrower honest? Will he make every possible effort to meet the terms of the agreement, or will he resort to tricks and evasions to avoid payment? How will he behave if repayment proves more difficult than he now anticipates?

Judgment as to the sense of honor of an individual or a nation with respect to the debt obligation is difficult at best, but the past record, when there is one, is perhaps the best guide. Those who lend to sovereign governments are helpless when it comes to collecting their loan unless the government is willing to pay, for they cannot use force, nor may they even sue in the courts to establish a judgment without the government's consent. Consequently, the record that a government has established with respect to past debt obligations becomes a significant index of the national character. Every broken debt promise, whether in major or minor details of the contract, reflects the underlying popular attitude toward the debt obligation. National character is not a fixed quantum. Nations with poor debt records may improve, and those with good records may deteriorate. The attitude of one generation is not necessarily that of another.

Public borrowing involves conflicts of group interest and prejudices so serious as to increase greatly the difficulty of appraising correctly the national or community integrity. The investor in public bonds is either a progressive citizen and a great patriot, or he is a grasping money lender. During the first World War those who subscribed to Liberty bonds were patriots, and the few who tried to avoid subscription, regardless of their reasons, were spies and traitors. Some of them suffered from mob violence. If an investor will buy a city's bonds he is a good fellow, but if he intimates that the city should not borrow any more just then, in view of its existing commitments, he is a Shylock, an obstructor of progress. Always, when the time for payment comes, the investor can be put in the wrong by being classed with the money changers. As individuals, people generally recognize the importance of living up to contract obligations; but the particular aspect of the economic conflict represented by the public debtor-creditor relation is one in which deep-seated prejudices are very easily aroused, and the appeal to this prejudice is a sure-fire demagogic trick.

Whether the appeal to prejudice is made to coerce investors into lending or to intimidate them as they attempt to collect the debt, it is always more likely to be successful when there is some doubt about the underlying justification of the loan. If borrowing has been undertaken without a first-rate case for it, the fanning of class prejudices is a good way to shift the blame. The ability to determine when, how much, and for what purposes, to borrow involves the second principle of credit, which is capacity.

Capacity. The capacity of those in charge of governmental affairs to make wise and proper use of public credit can be ascertained only by the pragmatic test. How do they use it, or propose to use it? In other words, for what purposes, under what circumstances, and by what governmental agencies is the use of credit justified?

The purposes of public borrowing. It must be remembered, in considering the appropriate use of public credit, that it does not mean a direct creation of wealth. Public borrowing is a method by which the government obtains command over purchasing power in the immediate present, in exchange for various sorts of promises to pay in the future. The effect of assembling a considerable aggregate of purchasing power under governmental control by means of a public loan may be beneficial or otherwise. Public as well as private expenditure means the purchase of commodities and services, and ultimately, the employment of labor in one direction or another. If the expenditure of the government loan results in a diversion of commodities and labor into wasteful and unproductive uses, there can be no addition thereby to the community's capital, but rather a loss of wealth and productive power. If the public funds that are provided by means of a loan are spent in acquiring capital goods or in the creation of new capital goods for the operation of some commercial enterprise, there may be an equivalent to the capital creation which might have occurred had the funds remained in private hands. Some part of the proceeds of public loans may be spent in the construction of public works and public buildings, which are socially advantageous and productive, though they yield no return on the outlay. Loans of this character contribute to the stock of social wealth, and within limits, sufficient social advantage may be realized from such debts as clearly to justify their burden.

It is possible that some persons have been misled by the view that is taken of the debts incurred by private concerns, such as utility or railroad corporations. In any summary of the amount of productive capital invested in the railroads of this country, for example, it would be proper and necessary to include the sums that have been secured by means of bond issues as well as those provided through the sale of stock. The debt of a railroad company represents productive capital, since it has presumably been invested in those forms of wealth which are a part of the necessary railroad equipment. In this case the railroad corporation has added to its stock of wealth through the use of credit. Whether the public loan increases the community's wealth or not depends entirely on the way in which the proceeds are spent.

Writers on public finance and the statesmen in charge of national finances have been divided into opposing camps on this question of the economic usefulness of public credit. On the one side are Smith, Ricardo, J. B. Say and Gladstone, who opposed the use of public credit on the ground that it led to extravagance, encouraged resort to war, and induced generally disadvantageous economic conditions for the nation which employed it. On the other side are Dietzel and various more recent German authorities who approve of the use of credit for financing all extraordinary expenditure on the ground that the state is part of the

immaterial capital of society and that any unusual outlay in its service is in the nature of an investment. In this view loans become a normal feature of the finances of the progressive state, and are to be regarded as both just and beneficial.

Neither of these extreme views can be accepted. The usefulness of the loan depends on the usefulness of the purpose to which it is devoted. The true function of public credit is to serve as a supplement to the current revenues under certain conditions. These conditions will be more fully discussed below. The emphasis here is on the proposition that the public loan is proper or not, according to the circumstances that give rise to its use. Credit is the handmaiden of taxation, never its peer as a financial resource. It is a useful and important device for meeting financial burdens that are too great for the immediate capacity of the revenue system, or which are of such nature as to warrant equalization of the load over a period of time. Unfortunately, the motive back of its use is sometimes the desire to evade the necessity of immediate taxation rather than to effect a more equitable distribution of the burden. That is, communities, like individuals, often permit expenditures to be made out of borrowed funds which they would not approve if made out of current funds, simply because the former looks like an easier way to pay the bills. The line between legitimate equalization of burden and improper evasion of the cost is not always easily drawn, and many specious arguments can always be found to prove that the thing which a community wants to do is the wise and necessary thing to do. This is not an objection to public expenditure or to the broadening wants of the community, but a reminder that those who dance to the music should liberally contribute to the fiddler.

The circumstances of public borrowing. The true function of public credit, as has been pointed out, is to serve as a supplement to the other sources of public revenue. The question then arises as to the circumstances under which it is legitimate for a state to borrow. In other words, what are the conditions under which the use of this supplementary resource are proper and justifiable? Assuming the legitimacy or the propriety of the expenditure, the problem becomes that of the choice of the means by which the necessary funds shall be provided. This choice ordinarily lies between loans and taxes.

It is evident that practical expediency will always play a large part in this matter. After the tax burden has increased beyond a certain point there can be little question, either, of a real choice between the two means. The loan will be used if it can possibly be floated. Politicians are usually fairly clever in gauging the popular inclination, and they would be the first to realize the practical unwisdom of increasing taxes as compared with the (temporarily) easier method of loans. There have been conspicuous instances of the failure of this political hypothesis, as in the

disapproval of Secretary Chase's loan policy during the Civil War. But granting that there is still a real choice open as between loans and taxes, the problem then is: when is it financially legitimate for a state to borrow?

Borrowing is legitimate to cover a deficit resulting from an unforeseen emergency. Increased taxation is usually not adequate for such situations, for some time is ordinarily required to get the tax machine running at higher speed, while the emergency calls for prompt action. Moreover, tax increases cannot always be made at a moment's notice on account of the desirability of preserving the balance of the revenue system. The increase of existing taxes may mean that a portion of the taxpayers are compelled to pay the cost of the emergency, while a new and broader tax requires time to become fully productive. Borrowing appears to be the only feasible method of providing immediate financial relief in a serious emergency situation.

The alternative possibility of carrying a treasury surplus that could be drawn upon in case of need was considered above. In addition to the difficulty of accumulating the surplus, there is the danger that it may prove an incentive to greater legislative extravagance. The history of the federal surplus revenues reveals how readily Congress has responded to this invitation to greater expenditures. Adams was so skeptical of American legislatures on this point that he believed a continual deficit to be about the only means of impressing them with the need to economize.

It should be said, however, that the regular recurrence of a deficit in the ordinary revenues cannot be met indefinitely by means of borrowing. Such deficits promptly lose their emergency character. If the expenditures are not kept down to the revenues, then the latter must be increased. Borrowing is permissible for the purpose of meeting the occasional emergency deficit, but if the shortage becomes habitual it is an indication that more revenue must be obtained. Borrowing to meet habitual deficits is merely the use of public credit to pay current expenses.

It is permissible also to use loans in financing an emergency, the cost of which is so great that taxation alone will not suffice. Modern warfare is so costly that the corresponding adjustment of the tax system has not usually been achieved, and an extensive, even an excessive, use of credit has frequently resulted. The problem of loans versus taxes will receive further attention in another place.⁵ Here it should be noted that borrowing, in proper relation to taxation, is permissible and proper in the face of such an emergency as war ordinarily presents.

The propriety of borrowing for the purpose of enabling the state to embark in commercial enterprises which may pay a return sufficient for interest and depreciation charges on the capital invested will depend upon the quality of public management and the other circumstances that

⁵ *Infra*, p. 540.

may be considered of sufficient weight to justify the undertaking. Many factors contribute to the financial success or failure of a public ownership venture, such as the capacity of the public administration in a given city or country, the policy of rates and charges which the public insists upon, and the degree to which the public enterprise operates under monopoly or competitive conditions. From the strictly financial standpoint it seems to be of doubtful propriety to borrow capital funds for investment in publicly owned and operated commercial enterprises unless these can be, and actually are, managed in such manner as to provide income sufficient to cover all necessary depreciation charges as well as the interest on capital. A community is always competent, politically, to decide upon the policy to be followed in the management of its commercial activities, and there may be numerous instances in which indifference to cost is justifiable. The survey of state and municipal industrial undertakings in Part II above has revealed some cases of this sort. Evidently, however, this policy cannot be extended indefinitely. The deficits must be met by the general taxpayers and a limit is reached presently to their ability to carry the burden. It would seem wiser as well as sounder policy to adopt a general rule of financial self-sufficiency for such enterprises, and to permit of departures from this rule in the interests of the consumers of the product or the beneficiaries of the service only under special and unusual circumstances.

There remains the question of the use of public credit to finance those projects and activities that are of general social advantage, but which do not afford any opportunity for a direct financial return. Highways, education, sanitation, public philanthropy and recreation are among the more important of these social activities and functions. How far is it proper to use public credit in providing the funds for these services?

No categorical answer can be given to this question. If a distinction be made between the current and the capital expenditures for these and similar activities, it is possible to say at once, that except for the most genuine cases of unforeseen and unforeseeable emergencies it is suicidal for a government to create permanent or long-term debts for the payment of current expenses. The line between current and capital expenditure is not always clear-cut, so it becomes necessary to establish this distinction somewhat arbitrarily at certain points. This is most conveniently done, perhaps, by taking a certain time limit or period of usefulness for all supplies, equipment and materials purchased, and declaring that all expenditures for whatever purposes, the results of which have a period of usefulness less than this minimum time, shall be treated as current expense.

The case of capital outlays for such improvements as school buildings, hard-surfaced roads, hospitals and other permanent equipment is one on which it would be difficult to secure unanimity of opinion. Nor is the

matter entirely clear from the standpoint of principle. If the debt maturities are arranged in accordance with the probable life of the improvements, and if the bonds are always redeemed and never refunded, a case can be made out for permitting the necessary funds to be raised by means of loans. The advocates of the loan policy for such improvements will contend that the taxes required to pay interest and sinking fund charges on the unredeemed installments of the debt would be balanced by the loss to taxpayers that would result if a very much larger tax levy were made outright in order to pay for the improvements in cash as they are constructed. If the outlay is so large that the tax would seriously retard industry and initiative this position is doubtless well taken. Credit enters as the useful and necessary supplement to current revenues for the purpose of spreading the burden over time, and so, in reality, of lightening it.

But it is also contended that the cash payment method deprives the taxpayers of the opportunity to invest that part of their incomes otherwise taken by the heavier taxes, and so over twenty years the real loss to the community is said to be as heavy as if a loan were made and the people were taxed for twenty years to pay the interest and redemption charges. For example, a school building may cost \$500,000. Unless statutory limitations on the tax rate interfered, a city might levy enough in one or two years to pay for such a building in cash when it was completed. On the other hand it might issue twenty-year bonds in payment. The tax levy for each year of this period would be increased by an amount necessary to redeem one-twentieth of the principal plus interest on all unredeemed principal. If the method of heavy taxation is used, the community is deprived outright of a large sum which it might have invested productively during the twenty years. On this reasoning, the advocates of a liberal use of public credit seek to demonstrate that the policy of heavy taxation involves a loss that is, in the end, about equal to the cost of the loans.

This argument in favor of borrowing for capital outlays has a certain validity, especially if it be granted that the community is one the members of which are keenly interested in increasing their investments, and are devoting all available income to this use. But against the argument are two strong practical considerations. First, the heavier taxes required to pay the interest and sinking fund charges are a certainty, while the gains which the taxpayers as a whole may realize by retaining and compounding the unpaid taxes (in case the loan is made) are rather uncertain. Indeed, it is highly improbable that the whole of their theoretical advantage will be realized, except by those whose taxes run to large amounts and who are constantly on the lookout for the opportunity to save and invest at every turn. To the extent that this possibility is not actually realized, the loan method does involve a heavier burden in the end.

In the second place, the community that has adopted the loan method

of financing all of its permanent improvement projects will find that in time it has about used up its available credit resources. Such a community is thus placed at a distinct and possibly a very serious disadvantage whenever a genuine emergency does appear. Public credit is not an unlimited resource. Rather, it is a limited resource the supply of which should be conserved in the main for those circumstances and requirements which cannot be fitted readily into the normal scheme of current expenditures and revenues. If it is used for defraying costs that should really be met out of current revenues, there will be no reserve protection against real emergencies. Since it is probably more costly to finance needed improvements in this way, a community that yields to the temptation to do so is inclined, without realizing it, to live beyond its means.

The rapid development of modern social organization and the growing complexity of modern social life have been very largely responsible for the scale of living that has been forced upon all nations and all communities within the nation. This pressure has driven the smaller and financially weaker states and communities into a volume of expenditure that is really beyond their means, and in order to maintain the pace they must borrow while their credit resources last.

The use of public credit to finance those improvements that are really in the nature of an extraordinary outlay becomes more nearly justified in the case of the smaller community. This harks back to the distinction between ordinary and extraordinary expenditure. Capital improvement expenditure becomes extraordinary and may be provided by means of loans if the outlay is so large as to impose an excessive burden on the resources of the community. These are relative matters, but there are practical signs which will guide the way. For example, when a city of, say, 5,000 population needs a new high school building, or a new hospital, such an expenditure may properly be regarded as extraordinary. It occurs, for a town of this size, only once in a generation. The cost would impose so heavy a burden on the resources of the community if levied outright as a tax, that the resort to public credit is proper and justifiable. On the other hand, a large city such as New York, Cleveland or San Francisco may require one or more school buildings every year. Under these circumstances the expenditures for public buildings become current, normal or ordinary expense, and should be met from current revenues. It is a foolish use of credit for large cities to build schoolhouses by such means, while it is a reasonable use of credit in the case of the smaller community. It probably costs more in the end to get school buildings that way, but one of the legitimate uses of public credit is to supplement and extend the purchasing power of the community in securing those things that must be had but for the provision of which the current tax revenues are inadequate.

The application of this distinction will naturally involve difficulties,

since there is no sharp line to be drawn between those cities which are small enough to treat a certain outlay as extraordinary, and those for which the same outlay would be a current expense. The soundest general principle in solving this practical difficulty is the pay-as-you-go policy, according to which public credit is relegated to its true sphere of supplementary current revenues.

The borrowing agencies. Little need be said about the agencies that should be permitted to borrow. Some governmental agencies do not have this power, but must operate on the funds raised and appropriated for their use by other agencies. The borrowing power is not a complete test of a governmental entity, for some agencies that are clearly not to be classed as units are empowered to enter into obligations to pay money.

The only point at which the question of the propriety of permitting exercise of the borrowing power arises is in the case of small local units which prove to be no longer competent administrative areas for certain services. Lacking the resources from which to derive sufficient current revenues to meet these costs, they are obliged to borrow while loans can be floated. Functional readjustments will lessen this pressure, correct the inequality of financial stresses, and eliminate the occasion for abnormal borrowing. Whether any governmental unit that is charged with definite functional performance on any scale should be denied the borrowing power is doubtful, although it is clear that careful supervision is required. In all cases, whether of small or large units, the use of credit involves, finally, the third essential, which is the ability to carry the loan.

Financial resources. Public, like private credit, is not credit at all unless there exists the ability to carry the loan, which means ability to pay interest and principal when due.

The normal long-run test of the ability to support debt is the amount of public income that is available for the debt service over and above the requirements of the debtor unit for ordinary current expenditure. Naturally, this surplus of revenue is a variable quantity. It depends on the taxable resources and on the willingness of the people to endure the taxes that may be required. The capacity of any government to support its debt is, therefore, both economic and psychological. Reference has already been made to the ease with which popular revolt against debt payment can be stirred up, and at bottom the subjective aspect of debt payment may be the determining one.

The possibilities of a capital levy for the purpose of reducing the war debts, or of extinguishing them altogether, were discussed in England, and in various other countries after the termination of the first World War. Assuming that such a plan could be carried through successfully, a levy upon the aggregate wealth of the community is not the kind of security that may safely be offered as the long-run basis of public credit. The capital levy is an emergency device that might possibly be used

once and once only, and the prospect of its recurrence would affect adversely the domestic credit of the nation which attempted it.

The relative ability to support debt varies also as between central and local governments. The latter are not free to make radical modifications in their revenue system, and in consequence their debt capacity is rather strictly limited by the constitutional or statutory framework under which they levy and collect taxes. When severe limitations are imposed on local taxation, local credit necessarily suffers since the ability to support debt is impaired.

On the other hand, the sovereign government is not so restricted in the exercise of the taxing power, except by the subjective resistance of the people. When there is strong opposition to taxation for debt payment, such a government has another alternative, in its control over the currency. A cheapening of the currency standard makes debt payment easier. While this is a partial repudiation, the government that engages in the practice usually faces a more disagreeable alternative if it attempts to collect taxes in sufficient volume to pay the debt on the standard by which it was contracted.

So much has happened in recent years to overthrow various accepted notions regarding the proper attitude of governments toward their debt obligations as to cast doubt upon the validity of some of the old canons. Some nations went cheerfully in default with respect to part or all of their public debt. A large number of cities and other local units likewise defaulted. The depression was held responsible, of course, although in fact the initial responsibility goes back to the fundamental disregard of the proper limitations on the use of public credit when borrowing rather than taxation was decided upon as the method of financing public expenditures. Essentially, therefore, the main defect was lack of capacity, in the sense that this term has been used here.

From the welter of default and repudiation in the history of public debt, certain emerging results seem clear:

First, it is useless to pledge or to specify any particular kind or medium of debt payment. The fate of the promise to pay interest and principal of public debts in gold coin makes this clear.

Second, the pledge of the full faith and credit of the borrowing government is still the best formal assurance that can be given, but a taxpayer's strike can easily reduce it to an empty promise.

Third, the experience of the depression and second World War periods suggests that governmental obligations are, essentially, as speculative as any other type of investment security. The purchaser takes, it now appears, a considerable risk of being paid at all; and a risk as to the kind of money he will receive; and a further risk as to when he will receive it. These are the risks that he takes in lending to a private borrower, and governments have abundantly shown that they are but little

more dependable than private debtors with respect to the fundamental obligations of the debt contract. Until there has developed a different attitude than has recently prevailed with respect to the limitations on the use of public credit, no other judgment can be expressed as to the credit rating of governments. Some notable exceptions can of course be found, but by and large there has been a decided decline in the morale that once justified the triple A rating of the investment counselor.

CHAPTER XXXI

The Management of Public Debt

IN THE USE of public credit, many important and difficult matters of policy and of technical procedure are involved. These matters include the determination of the numerous details relating to the form of the debt, the methods and terms of issue, and the provisions for redemption. They include also the contacts with the money market that is expected to absorb the offering. Decisions as to form, maturity, interest rate and the like are all conditioned on the market attitude. This chapter will deal with some aspects of debt management, with emphasis on points of general policy rather than on technical details.

THE FORMS OF DEBT

The most significant approach to the forms of debt is that of their maturity. In this respect the following main classes may be distinguished:

1. Perpetual debt
2. Definite principal maturity date
 - a. long-term debt
 - b. short-term debt
3. Annuity

These terms will be briefly defined and explained.

Definition of debt forms. The obvious distinction turns about the maturity. The *perpetual debt* is one that has no definite maturity date, and is, therefore, essentially an obligation to pay the current interest. Thus far it has not been used in the United States, but it is a popular device in England and France. The *terminable debt* is one, repayment of which is pledged on a certain date. Two subdivisions are conventionally distinguished, although there is no sharp line between them. *Long-term debt* is usually considered to include all maturities greater than five years, while *short-term debt* includes the maturities of five years or less. The short-term debt is sometimes called the unfunded or "floating" debt, but these terms also lack definite meaning. Ordinarily the floating debt is that with a maturity expressed in months rather than years. In England the *unfunded debt* includes all obligations that have

not been definitely converted into the Consolidated Debt by act of Parliament. Obviously, too, a debt issue that was in the beginning of long maturity passes over into the short-term category when it has less than five years yet to run. The distinction, though vague, has a considerable significance for the debt administrator, since the short-term debt includes that regarding which immediate plans for redemption or extension must be made.

The *annuity*, as a form of public debt, is similar to that used by insurance companies. In essence, the lender pays a principal sum, just as if he were buying bonds; but he is repaid by the debtor government in annual installments that include both interest and principal. The repayment may be made within a fixed term of years, or during the life of the annuitant. It is not recognized as a debt form in the United States, but it has been popular abroad.

The choice of debt maturities. The selection of debt maturities and the preservation of a proper balance among them is one of the most difficult aspects of debt management. Apart from the market preference at any given time for one type or another, the treasury objective in the adjustment of maturities is to provide the maximum current freedom in dealing with the financial emergency, and at the same time to achieve the minimum necessary increase of the ultimate overall burden of interest and redemption. These aims are not wholly consistent, and it is evident that there will ordinarily be some compromise between the two, through the use of both long and short maturities. The determination of the best balance between long and short maturities requires thorough understanding of the nature of these conflicting objectives, and keen foresight, or great good luck, in judging the duration and the probable financial burden of the emergency. As will be seen from the discussion of federal debt policies in the next chapter, the consequences of error are likely to be serious.

The advantage and disadvantage of long-term debt. The principal advantage of long-term debt is that it postpones the question of redemption, and thus relieves the debtor government from a possible source of financial embarrassment during the emergency. The duration of a war or an economic depression is unpredictable, at the outset, and wise policy dictates the establishment of rather long maturities in order to permit some measure of recovery before the bonds must be redeemed.

The disadvantage of this debt policy is obvious, since interest costs are a function of time. The longer the debt runs, the greater is the interest cost. At 4 per cent, the simple interest will equal the principal in twenty-five years. Hence, borrowing at 4 per cent for twenty-five years means, in the end, paying two dollars for every dollar originally received from the loan. If it were possible to repay the loan in ten years, the interest cost would be only \$400,000 on each million dollars of principal.

The objection to long maturities can be met in part by providing that the bonds may be called for redemption after a certain date. Unless the call date is set ahead some years, however, the investment attraction of the long term disappears, and the market reception of the issue may be unfavorable.

The forms of short-term debt. There are three principal forms of short-term debt. These are (1) the demand note, (2) the treasury warrant, and (3) various treasury obligations, such as the bill, the note and the certificate of indebtedness. They will be briefly explained.

The demand note. In form, the demand note is a promise of the issuing government to pay a certain sum of money on demand. It is usually printed in denominations suitable for general circulation. When issued by the national government, it can be given legal tender power, which enforces its acceptance and circulation. If the demand note is adequately secured by a standard money reserve and is freely redeemed from this reserve on demand, it becomes a form of paper currency the case for or against which may depend on circumstances. When such notes are issued on any extensive scale, it usually signifies an inability to pay expenses in any other way, and hence an inability to redeem them in standard money. As "fiat" currency, the value or purchasing power will then depend mainly on the quantity issued. Resort to irredeemable demand notes indicates the beginning of paper currency inflation, with all of the dangers that accompany this step.

The treasury warrant. The warrant is an order on the Treasury, in ordinary bank check form. It is the instrument by which all disbursements are made. When warrants are issued in excess of the funds in the Treasury, they become a kind of short-term, compulsory loan made by the person who has sold materials or performed services, since the holder must wait until taxes or other treasury receipts permit payment. Local governmental units have been the worst offenders in over-drawing against their treasury funds, and their employees have been the chief sufferers. When the original recipient of the warrant cannot afford to wait, he must discount the warrant at the bank, or in payment for rent or groceries. The uncertainty as to the date of redemption leads to excessive discounts, and thus throws upon public employees the burden of lending to their government at the equivalent of an excessive rate of interest.

The short-term treasury obligation. Three principal types of short-term treasury obligation have been developed. The treasury bill is similar to the commercial bill. It calls for the payment of a given sum on a certain date. The investor buys it at a discount determined by market conditions for short-term high-grade paper. The amount of the discount is obviously the interest paid by the government for the loan. The treasury certificate of indebtedness may be issued for various purposes, but the most important are the anticipation of tax receipts and the anticipation

of subscriptions to long-term loans. Such anticipation certificates are receivable for taxes, or for payments on loan subscriptions, respectively. The maturities of bills and certificates never exceed one year, and are usually from two to six months.

The treasury note is a straight-forward interest-bearing obligation, maturing in three to five years. It differs from the bond only in its shorter maturity.¹

The banks are the principal source of short-term funds for governments, but the bank loan is ordinarily secured by some one or more of the foregoing types of obligation.

The proper uses of short-term debt. There are two general situations in which the use of short-term debt is justifiable and legitimate. One is the equalization of revenues and expenditures during the fiscal period, and the other is as a preliminary step in the execution of a program of long-term financing. In neither case should there be a net addition to the permanent debt as a result of the temporary financing.

The equalization of revenues and expenditures. It is well understood that public revenues and public expenditures are not always perfectly balanced at particular moments of time, however exactly they may be balanced for the fiscal year. Disbursements may go on in a fairly regular stream, while the revenues come in irregularly. In local finance there is often marked discrepancy between the budget year and the tax collection year. While temporary borrowing is permissible for equalization purposes under these circumstances, a far better approximate solution would be a closer adjustment of the two fiscal periods, in order that part, at least, of the revenues for the support of any particular budget may be received, under installment tax payments, in the early months of the budget fiscal year. Cities and other local units are spending in the aggregate millions of dollars every year on temporary equalizing loans that could be saved by closer synchronization of the tax and the budget years. This would not entirely eliminate such loans, but it would greatly reduce their volume and their cost.

It is necessary to insist that temporary loans made for the purpose of equalizing budget operations shall not result in adding to the net indebtedness of the governmental unit. If this result does ensue, it amounts to borrowing for current expenses, a practice the unwisdom of which under normal conditions requires no comment. Local governments are likely to be serious offenders in this respect, particularly when there is a great lag in the tax collection year. Expenditures will be made according to the budget, on the support of temporary loans, and usually on the assumption that the whole of the tax levy will be collected. Insofar as this assumption is not met, the temporary loans cannot all be repaid, and

¹ In general investment terminology, long-term obligations are called *bonds*, and short-term obligations are called *notes*.

some part must therefore be carried over into the next year. An increased tax levy is likely to fail in providing enough for current purposes and the repayment of the balance of the temporary loan, unless drastic budgetary revision has been undertaken; and the eventual result of this accumulation of temporary debt will be an addition to the funded or long-term debt.

The abuses of temporary local borrowing have been so serious in some places as to lead to other plans for equalizing the budget. These contemplate, in some fashion or other, restriction of expenditures to the revenues actually received. A strict pay-as-you-go policy is more easily applied if the synchronization suggested above is introduced. As an approximation for determining the rate of expenditure under it, reference to the recent tax collection experience of the unit is also helpful. That is, if the taxes actually collected in any year amount to, say, 70 per cent of the levy, then only this percentage of the current levy should be relied on as available in making the appropriations.

The anticipation of long-term borrowing. Short-term paper may properly be issued as a preliminary step toward a long-term bond issue. There are two types of situation that may give rise to such preliminary financing. One is the pressure for funds during a serious emergency. Large long-term bond issues require a certain amount of advance planning of details, preparation of the banks or the public for the issue, and so on. The sale of loan anticipation certificates receivable toward bond subscriptions, enables the government to collect and make use of some part of the proceeds of the ultimate loan in advance of its issue. The certificates not actually surrendered for bond subscriptions will of course be redeemed from the cash proceeds of the bond sale.

The other situation is more likely to arise in connection with local improvement financing. Although an outside limit of cost may be set, the precise amount that will be required cannot always be determined in advance. Temporary borrowing to cover the actual financing, with provision for funding the temporary paper when the cost is known, is often a convenience. The maturity of the temporary loans should be sufficiently restricted to compel an early determination of the ultimate bond issue, and there must be rigid control to assure that the short-term loan is completely taken up as the permanent bonds are issued.

The treasury bill, which is also used by the English treasury as a means of equalizing expenditures and revenues, resembles the bill of exchange in its forms and method of issuance. The use of such bills by the Treasury was suggested by Walter Bagehot, who first appreciated the possibilities of short-term public financing by means of the discounted bill. Like the bill of exchange, the treasury bill is drawn for three or six months, and is discounted by the purchaser at rates which are below, but dependent upon, the market rate for high-grade private bills.

Extensive use has been made, both here and in England, of savings stamps as an adjunct of war finance measures. The stamps, of varying small denominations, were pasted into books, which were exchangeable for savings bonds of appropriate amounts. The stamps bore no interest.

METHODS AND TERMS OF ISSUE

Another aspect of debt management is the technique of floating the loan and determining the terms of the contract. Both of these problems involve close contact with and an extensive understanding of the sources of the funds that may be drawn upon to absorb the offering.

Flotation. The available alternatives of disposing of the loan paper are sale to bankers, sale to the public by general subscription, or sale on the bourse or exchange. The last of these methods is used abroad, where the investing public has become accustomed to it. Practically, the choice in this country lies between the first two methods.

From the standpoint of the nature of the approach to the public, three policies may be distinguished. The loan may be compulsory, or it may be made on the basis of a patriotic appeal, or it may be offered on a business or investment basis.

Compulsory loans. The compulsory loan is a method of taking private wealth for public purposes. Nominally it differs from taxation in that the state undertakes to repay the amount contributed, but an important form of the compulsory loan, the inconvertible legal tender demand note, is likely to be issued in such quantities, once the movement sets in, as to culminate finally in the utter worthlessness of the promise to pay.

Compulsion to secure subscriptions to the ordinary type of bond issue is no longer in vogue, although the excesses committed by some of the "wrecking crews" in securing subscriptions to the Liberty Loans were vicious enough. The use of force and violence to compel subscriptions was not authorized by the government, but there was no official rebuking of those employing such methods. Persuasion was employed in securing agreements to bond purchase plans by payroll deductions, during the second World War. No repetition of the procedures sometimes used during the first World War seems to have occurred.

The provision of credit support by the use of force or compulsion cannot be condemned too severely. It means an unjust and inequitable distribution of the cost of government, since the creditors have no choice but to submit to terms in the determination of which they have had neither voice nor influence. If paper money is used, there is the additional danger of overissue, with the resultant inflation of prices and serious dislocation of economic interests. Once a government has started on this slippery downward path there is the greatest difficulty in avoiding complete financial collapse, as is clearly shown by the experience of the

American states during the first war with England, by the French experience during the French Revolution, and by the Russian, German and Austrian experience after the first World War.

Compulsion, moreover, deprives the borrowing operation of all vestiges of a contract transaction, and, indeed, of a credit transaction. It is fundamentally inconsistent to speak of a compulsory loan, since the basis of any credit transaction is confidence, and confidence flies out the window as force comes in at the door. The process is really one of commandeering private wealth for public purposes, and its real nature is not disguised by being clothed in the form of a loan.

Patriotic loans. The appeal to patriotism and sentiment is also objectionable as the basis of floating a public loan. The point of the patriotic appeal is that the government seeks thereby to secure its funds on terms more favorable to itself than would be possible otherwise. The appeal is the short-circuit one to the emotions of the subscribers, instead of to their self-interest and their common sense. The government cannot expect to get something for nothing and avoid the reaction which usually comes when people discover their mistake. Even if some considerable amount could be secured on this basis while the tide of national feeling is running high, the ultimate reaction is almost certainly unfavorable to the government and to its future efforts at borrowing. A tide of patriotism may "float" a loan, but will not necessarily keep it above water.²

The business basis. The only practical basis of floating public loans is, therefore, the presentation of the request for funds on strictly business principles. The greatest success in making loans will be achieved by those governments which present terms that are attractive to the investors, not only with respect to the rate of interest to be paid, but with respect to all other features of the loan. As a borrower the government is competing with private industry for a share of the available surplus funds of the community, and it will fare best in this competition if its appeal is made in a straightforward way to the economic self-interest of the savers who are to provide the funds.

Sale to the banks or the public. While the support of the banking organization and interests is always essential, and state and local bonds are invariably sold to them, it is probably advisable, for political reasons,

² There was a general impression that the Liberty Loans were true patriotic loans, in the sense that the people were quite willing to take them, without regard to their investment features, as a necessary means of seeing the war through. This does, no doubt, describe accurately enough the attitude of many subscribers. But on the other hand, there was tremendous pressure put on every one to subscribe. Valuable tax exemption and conversion privileges were attached to these bond issues. The Treasury was being authorized to use part of the proceeds of one loan to sustain the price of earlier issues, banks loaned at coupon rates to prospective subscribers, and accumulated on their own account increasing quantities of the government's war paper. In view of these considerations, the attempted reliance on patriotism to sell the war bonds may be set down as one of the mistakes of the period.

to offer federal debt paper at public subscription, in which the banks participate along with the investing public at large. The loans that the Treasury made in 1895 for gold to maintain the solvency of the government were taken by a banking syndicate. Despite the fact that the Treasury's predicament was in large part the fruit of demagogic finance, and the further fact that a publicly offered loan had failed, the announcement of the syndicate was greeted with clamor and denunciation on all sides.³ The historical emphasis in the United States on an independent treasury, coupled with a traditional popular suspicion of and hostility toward banks, has doubtless contributed to this attitude. It is quite possible, however, that the advertising and other expenses incident to a general offering run higher than the commission that would be allowable to the banks in the event of an underwriting for resale to their customers.

It has been proposed at various times that the Treasury Department be authorized to sell bonds directly to the federal reserve banks. This proposal has been opposed and should never be adopted. These banks are under fairly complete government influence, even domination. They are in no position, therefore, to act independently, whether as a critic of the contemplated fiscal action or in other ways. Even the federal government needs the information to be had from exposing its policies and program to the independent appraisal of the market. The federal reserve banks may buy government bonds in the open market, as anyone is free to do.

It is probably not feasible to invite competitive bids for a large loan offering. If sufficient support could be secured in this way the government might gain from the premiums that investors would pay for the privilege of subscription. On the other hand, there is a definite tactical advantage in a complete statement of all the terms of sale, especially if these are certain to be favorable enough to make an investment appeal. In the event of oversubscription the Treasury may then curtail the large bids or employ discretion in other ways to insure a wide distribution of the loan.

The general absence of adequate state supervision of local finance has been a handicap to the smaller local units in selling their bonds. The issues are often small, and the best terms are not always secured when negotiations are handled directly by the small town officials. The North Carolina local government act of 1931 requires that all local bonds be advertised and sold by the local government commission, acting on behalf of the cities and other units.

The terms of issue. The terms on which the bonds are to be issued involve such matters as the interest rate, the maturity, the callability, the privilege of conversion, taxable status, and the like. In the aggregate these features of the loan will determine its reception by banks or investors,

³ A. D. Noyes, *Thirty Years of American Finance* (1898), p. 236.

and thus reveal the price at which it can be sold. If the debt is to have a definite maturity date, every consideration leads to the conclusion that it should not be sold at a discount. The immediate gain, which is usually in the form of a lower interest charge, is often offset and sometimes exceeded by the necessity of issuing a larger nominal total to provide the required funds, and thus of a heavier burden of redemption. A higher interest rate causes a greater temporary burden, though it may not be much less than that produced by a lower rate on a larger nominal principal, and there is the further advantage that the interest cost may be reduced later by a successful conversion.

Additions to the English Consolidated Debt may be sold below par, since much of this debt is now carrying an interest rate of only $2\frac{1}{2}$ per cent on the nominal amount. But the English "Consol" means nothing more than the government's promise to pay interest at the rate of £2 10s per annum for every nominal £100 held. The market price of Consols fluctuates with variations in the current rate of interest and other factors, so that new offerings must be priced with some regard to the existing market price of the old stock. In order to make the new flotation attractive to investors the offered price must be somewhat more favorable than this market price. The government does not lose the full amount of the discount in subsequent redemptions of the debt, however, since, it, too, may buy Consols in the open market. As long as the market price is below par this method of debt redemption will always be used.⁴ The loss, if any, will depend upon the margin between the price at which new debt is sold and that at which redemptions are being purchased.

Variety of debt forms. A final question arises with regard to the desirability of variety in the loans offered. To what extent should the types of debt obligation differ with respect to interest rates, tax exemption privileges, conversion privileges and other features? This assumes, naturally, a debt of some size and a fairly prolonged borrowing program, as in case of war. Adams, concludes, rather noncommittally, that it is well to have some, but not too much, variety. The case for variety is based on the ground that the government is a seller, and in offering its bonds to the public it should, so far as may be consistent with sound financial principles, seek to adapt its wares to the fancy or preference of the buyers. European states do this to an even greater degree than does the United States.

During the first World War, the several Liberty Loan issues carried diverse interest rates, conversion, and tax exemption privileges. This was probably a mistake, as Plehn argued.⁵ In the second World War all issues were taxable, and only two general types were used. These were the savings bond, sold at a fixed discount and redeemable at par after 10 or

⁴ E. Hilton Young, *The System of National Finance* (1915), p. 276.

⁵ C. C. Plehn, *Introduction to Public Finance*, 4th ed., p. 369.

12 years, and the customary bills, notes, and bonds. No conversion privileges were given. Tax anticipation certificates were offered, but there were no loan anticipation certificates.

THE REDEMPTION OF DEBT

The use of credit implies the creation of an obligation to repay or return something of value in future. Present command over purchasing power, and thus over commodities and services, is obtained in exchange for promises to repay purchasing power in the future. A loan is, therefore, an incomplete transaction until the debt is repaid and it may seem superfluous to raise the question whether public debts should be redeemed.

Stated thus, there would be general agreement with the principle, with the possible exception of the self-sustaining utility debt. Public debt should be redeemed sometime. Practically, however, the difference between terminable and non-terminable debt is one of redemption or not, rather than a question of doing it on a definite date or at convenience. Experience shows that it is never convenient, hence it is reasonably correct to say that there is not much intention on the part of the countries with large amounts of non-terminable or perpetual debt, to redeem it.

Advantages of the perpetual debt. Two arguments may be urged in support of the perpetual or indefinite maturity debt. The first is that the annual burden of the debt is less, since there is no necessity of including sinking fund or amortization charges. It becomes easier, therefore, for a nation to carry a heavier load of debt in this form than would be otherwise possible. But against this argument in favor of the perpetual debt must be placed the fact that modern debts have increased so rapidly as to cause a well-nigh unbearable charge for interest only. In other words, the absence of definite amortization plans has not kept the debt burden down—it has simply made it possible for a country to carry a larger amount of principal. If a government is obliged to plan for debt repayment at a definite date, greater care will presumably be exercised in the volume of obligations which is assumed. This possibility, incidentally, is the only disadvantage of the perpetual debt form which is admitted by Allix, who defends the type at some length.⁶

A second consideration in favor of this method of creating debt has greater importance. It is the fact that the government is never in default on its credit obligations through failure to redeem any part of the debt at a specified time. The advantage lies with the treasury, which may call certain portions of the debt as conditions warrant or when the terms of issue will permit. The government may also practice redemption by

⁶ E. Allix, *Traite elementaire de science des finances et de legislation française* (1931), p. 898.

purchasing shares of the debt in the open market if the quotation is below par. Since redemption is entirely optional, the government's credit does not become clouded by failure to exercise the option.

On the other hand, the option to redeem or not presents certain disadvantages. The fact that debt redemption may always be postponed to a more convenient season, is in itself, a powerful temptation to the administration in power to use the available money in other ways, or sometimes to cut away the surplus by reductions of taxes, and thus actually to postpone redemption. The result is likely to be, therefore, that redemption of debt proceeds but slowly. This point is stressed by E. Hilton Young, in his study of the British financial system. Since there is no immediate urgency in providing for the sinking fund, there is always some more pressing use for the money, such as the "Circumvallation of Cuckoos" or similar worthy object. Next year is always considered time enough to begin with the sinking fund payments. But next year there must be a still higher wall built about the evasive cuckoos, and so the debt is again neglected.⁷

The French author, Allix, already referred to in this connection, sees various other advantages in the system of perpetual debt. He points out that the state is eternal, and that the lender need not, therefore, have the same hesitancy about an indefinite loan to the state as he might be justified in having when asked to loan for an indefinite period to a private debtor. This method also gives the state an advantage in conversion operations, and the relative annual interest burden may be lessened, not merely through the reduction of the rate in favorable conversion operations, but also on account of the progressive depreciation of the metals and the growth of the national wealth. Bastable has emphasized the folly of relying on the course of depreciation or upon the progressive increase of the national wealth, as the means of lightening the burden of the public debt. With regard to conversion, it might be pointed out that this procedure is less likely to be necessary if a vigorous policy of redemption is carried out. It is true, as is pointed out below, that conversion and the indefinite debt appear to go together. Conversion is not a necessarily desirable end in itself, but a device that is forced upon the state by the desire to reduce a burden of debt which cannot be redeemed.

Self-sustaining public enterprise debt. It may be agreed that public enterprise debt supported by the earnings, representing an investment of capital in the publicly owned economic enterprises, need not be redeemed, provided the accounting and business methods followed in the management of the undertaking are such as to insure adequate safeguarding of the capital through proper depreciation and reserve charges. It is unnecessary, strictly viewed, to set higher standards in these respects for publicly than for privately owned utilities. The danger is, however,

⁷ E. H. Young, *op. cit.*, Ch. XI.

that the proper charges to protect the capital will not be made, and if this proves to be the case, the outcome will be a rundown plant with an unredeemed debt in the bargain.

Reasons for debt redemption. With respect to all other public debt, a general policy of redemption appears desirable for the following reasons:

First, redemption puts an end to the tax burden on account of interest. While the taxes are of necessity heavier during the period in which redemption is taking place, this period ends when the debt is paid, and taxes may then be lightened for all time to come, so far as this particular debt is concerned.

A second advantage of redemption is that the public credit is thereby strengthened for any subsequent emergency. This comes about because of the greater security for a loan which a nation with little or no debt can give over that offered by a nation already heavily burdened. The security back of a public debt is, ultimately, the ability and willingness of the people to pay the taxes involved. There can be no argument over the superiority of the redemption policy on this score.

While a general policy of debt redemption is wise, it must be admitted that if a government's financial situation is such that it can be accomplished only by the imposition of very severe, or very undesirable, taxes, the case becomes at best a choice of evils. These conditions are always relative; the decision must therefore rest on the comparative undesirability of the taxes and of the debt. It would be inadvisable to levy a tax that was clearly and demonstrably objectionable in its effects for the purpose of hastening debt redemption. The objection that the taxes required for this purpose are merely an added burden is not valid. Taxes are always a burden and their imposition for debt repayment will never be a painless operation. Public credit is not indefinitely expansible, nor is it a boundless reservoir that may be drawn upon indefinitely without replenishment. Redemption of debt is the surest means of improving the public credit, and some policy looking to this end is a fundamental feature of every sound financial system. Public debt should be redeemed as promptly after its creation as circumstances will permit. The earlier this result is obtained, the sooner may the productive forces be freed from the burdensome taxes required for interest and amortization. The advantage of a perpetual debt is illusory, since it leads gradually to an aggregate principal which cannot be redeemed and which, therefore, is truly a perpetual burden.

Methods of debt redemption. The next question that arises is as to the method by which redemption is to be accomplished. Three general methods present themselves—first, the government may purchase its bonds in the open market or accept them in payment of taxes and cancel them as acquired; second, some regular plan of retirement may be set in opera-

tion, such as a sinking fund, or the designation by periodic drawings of certain numbers to be called for redemption, or retirement according to serial maturities; third, the debt may be redeemed by a capital levy. Each of these methods calls for brief consideration.

As a preliminary to this discussion it should be noted at the outset that the only valid source of the funds with which redemption is to be effected is a surplus of revenues over other expenditures. It is unnecessary to waste time in considering the possibilities of compound interest, a magic wand with which finance ministers once hoped to conjure away the debt. Given a financial situation that will provide surplus revenues for the purpose of debt redemption, it becomes a question of the alternative methods of using this surplus to accomplish the desired end. Evidently some thought must be given to the anticipated means of redemption at the time the debt is created, or some, at least, of these methods would be inappropriate.

Retirement by purchase. Open market purchase is advantageous when the debt is selling below par. The securities may be purchased on the exchange, or tenders may be invited of the prices at which holders would be willing to sell. The federal treasury has frequently purchased federal securities in the market, and in some cases large premiums have been paid. The most conspicuous instance occurred during the 1880's, when the treasury surplus was large and political conditions militated against a reduction of the tariff, the principal federal tax. This particular treasury surplus would probably have been wasted in other ways, anyway, so such comfort as is possible may be found in the thought that the public debt was reduced and the interest charges stopped. For some years after the end of the first World War the Treasury bought federal bonds and notes in carrying out the provisions of the sinking fund law. The first installment of the British war debt to the United States was paid in Liberty Bonds that had been bought in the New York market at prices somewhat below par. Federal bonds are receivable at par in payment of the estate tax, but there is obviously no advantage to the taxpayer unless the market price is less than par.

The success of this means of retiring the debt naturally depends on the market. As the emergency which gave rise to the debt passes and the government credit improves, the bonds frequently go to a premium, and open market operations then lose their attractiveness to the well-managed treasury.

A definite redemption plan. The application of surplus funds to debt redemption in accordance with a definite plan must be anticipated at the time of issue, in order that its details may be made part of the contract entered into between the state and its creditors. The principal alternatives here are selection of the bonds to be redeemed by drawings, or by serial maturities.

Drawing, or designation by lot, has not been used in American public finance, although it is not unknown in private financial practice. Retirement of the later issues of the Liberty bonds by the Treasury was determined by reference to the characteristic letter and certain numerals in the serial numbers, but these were all refunded in such short time that no particular advantage accrued to those whose bonds were not included in the first designation. The selection by lot has been employed fairly extensively in Europe, but too frequently there has been the complication of lottery devices, such as prizes to the holders of certain numbers. The prizes are supposed to afford an offset to the risks involved in an early termination of the loan contract. This method is of little advantage to the Treasury, for the prizes are a drain on the revenues, and investors are less inclined to venture large sums in a bond issue which is removed from the investment field by the introduction of prizes and other speculative features.

Serial bond redemption. The regulation serial bond issue is one which provides for the maturity of a portion of the bonds in each year, the order being determined by the serial numbers given to the several bonds. This type of bond is becoming popular in local finance and in some fields of private finance. A growing number of state debt statutes require serial bonds for all local units. The plan has the great advantage of compelling the debtor government to count the whole cost of redemption within the period established before floating the loan, and to levy taxes sufficient to carry interest charges plus serial redemption requirements. It obviates the necessity of accumulating large amounts for redemption purposes and of carrying these funds in liquid form through the various changes in the political administration of the government. The record of local sinking fund administration in the United States is a sadly tarnished one, and the tendency toward serial redemption of local bonds is entirely praiseworthy.

The objections to the serial bond form are no longer important, from the standpoint of local financing. It is true that this type is not as suitable as long-term bonds for meeting emergency requirements. The necessity of levying taxes for redemption within two years or so from the date of issue not only increases the current tax charges on account of the debt; it may mean the obligation to redeem a part of the loan before the emergency has really passed. For this reason serial issues are likely to be as unattractive for national governments as an unwise use of short-term loans would be. But it is seldom necessary to make local loans under prolonged emergency conditions, so this objection has little weight in the field of local finance.

It is sometimes urged, also, that a serial bond issue cannot be sold on quite as favorable terms as might be secured for a long-term issue, since investors usually prefer long-term placement of their funds. But the serial feature gives a certain variety to the issue, and the volume of public

securities is now so great that the demand for long-term investments can usually be satisfied out of the later maturities, while the earlier maturities are more attractive to those who may desire a more liquid investment.

Serial redemption may be accomplished in either of two ways. An equal proportion of the bonds may be retired in each year, in which case the tax burden is heavier in the early years on account of the larger amount of interest on the unredeemed portion, but this is offset by a rapid decline in the tax burden toward the end of the period. Another method is to levy a fixed amount of tax throughout the period, applying the greater part of this yield to interest in the earlier years and a greater part of it to redemption in the later years. Neither method is superior to the other in principle, and the choice must depend on the circumstances.

Sinking funds. Another method of redemption is by the use of a sinking fund. The original meaning of the term was that of a fund which was accumulated, during the life of the debt, with a view to redeeming or "sinking" the principal at its maturity. The general idea of debt redemption by this means is an old one. It was given extraordinary vogue at the end of the eighteenth century by the writings of a certain Dr. Price, who set forth in glowing terms the beauties of compound interest as a means of debt repayment.⁸ Insofar as his argument dealt with the enormous possibilities of increase in any geometrical progression, it was obviously sound, from the standpoint of mathematics. As soon as it was transferred to the realm of finance, administered by practical politicians, its shining qualities of mathematical exactness became a will-o'-the-wisp, an *ignis fatuus*, which drew its followers deeper and deeper into financial quagmires. Price's scheme was given a trial in England by Pitt, but the treasury was soon manufacturing new debt more rapidly than the sinking fund could grow at compound interest. Alexander Hamilton was undoubtedly influenced by Price's reasoning and by Pitt's example, and his early arrangements for redeeming the federal debt reveal traces of this influence. Hamilton has been exonerated from the charge that he was relying upon the magic of compound interest to redeem the debt, and by 1817 all vestiges of the complicated sinking fund machinery that he had set up had been swept from the statutes. Thenceforward the policy of debt redemption rested upon the simple yet effective device of appropriating surplus revenues to this end, and by 1835 the United States had the distinction of being entirely out of debt, a distinction shared by no other important country during the nineteenth century.

The expression *sinking fund* has come to have a different meaning in modern times from that which was associated with its use a century ago.

⁸ Cf. C. J. Bullock, *Selected Readings in Public Finance*, 2nd ed., Chap. XXI, for an account of Price's views, and of Robert Hamilton's criticisms. See also F. W. Hirst, *The Political Economy of War* (1916), Part II, Ch. I, and A. D. Chandler, "Amortization," *American Economic Review*, Vol. III, p. 876 (December, 1913).

It means now simply the funds that are earmarked or definitely put aside for debt redemption. There is no longer any attempt to carry this fund to the maturity of the debt and accumulate its interest earnings by compound interest. The general practice is, rather, to use the money that is appropriated for sinking fund purposes for annual or other periodic purchase or redemption of debt. If the bonds mature serially, the money provided each year remains in the sinking fund account only from the date of tax collection to the date of bond maturity. Annual retirement of term bonds is usually accomplished by having the Treasury receive tenders of the bonds to be purchased with the funds available, and from among the offerings submitted to accept those most favorable in an aggregate that will absorb the appropriation.

The capital levy. Another suggested method of debt redemption is by the outright imposition of a very heavy tax on property. Instead of eliminating the debt by the rather slow process of applying annual revenue surpluses over a considerable period, this plan would undertake the extinction of all or a large part of the debt by a single levy on accumulated wealth. The idea is not new, for both Ricardo and Mill considered it as a means of freeing governments from debt. The former's attitude was favorable to such a method, while the latter viewed it with approval providing it were practicable.⁹ The suggestion was revived in various countries during and after the first World War, and in some legislation was actually undertaken. A similar proposal in one of the few neutral states, Switzerland, was decisively defeated in a popular referendum on the act which the legislature had submitted.¹⁰

The objections to the capital levy for the wholesale redemption of debt are, as Bastable says, overwhelmingly strong.¹¹ The public debt is an obligation of the entire state, and not merely of the property owning class. The capital levy would impose the entire burden of debt repayment on property owners, since there is no way of distributing a fair proportion of the burden to those whose incomes are not derived from property. Mill recognized this difficulty, and because of it he was forced to the conclusion that such a method of reducing debt was impracticable. "Whatever is the fitting contribution of property to the expenses of the state," he says, "in the same and in no greater proportion should it contribute towards either the interest or the repayment of the national debt."¹²

One of the ablest advocates of the capital levy in England, Professor A. C. Pigou, admits that since the levy is to be made on the *fund* of

⁹ D. Ricardo, *Works*, p. 149; J. S. Mill, *Principles of Political Economy*, Ashley edition, Book V, Ch. VII, pp. 876, 877.

¹⁰ W. E. Rappard "Demagogy versus Democracy," *Political Science Quarterly*, Vol. XXXVIII, pp. 290, 361 (June, September, 1923).

¹¹ C. F. Bastable, *Public Finance*, p. 708.

¹² J. S. Mill, *Principles of Political Economy*, p. 877.

resources as of a given time rather than on the flow of income, perfect fairness would require the inclusion of all personal ability, mental and manual, as well as all property.¹³ The accurate appraisal of ability, especially in view of the uncertainties of life for the individual, is so difficult as to render its inclusion virtually impossible. Professor Pigou then proceeds to demonstrate to his own satisfaction that the omission of personal ability would, after all, be only a little unfair and hence not a valid objection to the whole scheme.

There is no way of contesting this conclusion for England; but in view of the relative proportion of personal and property incomes in the United States, as disclosed by federal income tax returns, such an omission would be decidedly discriminatory against property owners as such. The problem of a proper assessment of trade assets, household goods and miscellaneous property, comprising altogether for England about 20 per cent of the total wealth, according to Pigou's estimate, presents administrative difficulties so great as to compel the suggestion that the assessment on these classes be deferred until they next become subject to the estate duty. The possibilities of ultimate evasion thereby offered are admitted to be very great, but unavoidable. In reality, then, Pigou's proposal boils down to an immediate levy on the standard forms of wealth: stocks, bonds, mortgages, cash and real property.

Many proponents of the capital levy have been more concerned with some of the defects in the economic situation during and since the first World War than with the true nature of the public debt and the most equitable means of redeeming it. This apparently, was the basis of the Labor Party's advocacy in the early 1920's since its members were not the chief sufferers under the British income tax. Their ire was aroused at the excessive profits gained by some of the war contractors, and the discrepancies and divergencies in the distribution of wealth that emerged during the strain of the conflict. The capital tax was advocated, therefore, primarily as a corrective for the existing inequalities in the distribution of wealth, and not simply as the most satisfactory means of redeeming the debt. Such arguments as those advanced in Hobson's *Taxation in the New State* relative to the unearned character of large fortunes and of great increases in wealth, suddenly attained, have supported this view.

The agitation in England resulted in the appointment of a Parliamentary committee, which submitted in 1920 a plan for a capital tax in the form of a special levy on war wealth.¹⁴ The assessment for this tax necessitated two valuations, one as of 1914 and the other as of 1919. The measure was an active issue in two political campaigns, but was dropped

¹³ A. C. Pigou, "A Special Levy to Discharge War Debt," *Economic Journal*, Vol. XXVIII, p. 135 (June, 1918). See also this author's *A Capital Levy and a Levy on War Wealth* (1920).

¹⁴ *Report of the Select Committee on Increase of Wealth (War)*, Cmd. 1920, Vol. VII, No. 102. An appendix contains the report of the Board of Inland Revenue.

by its advocates, the Labor Party, which came into a short-lived minority control of the government in 1924. A plan was worked out by the Board of Inland Revenue for the application of the tax that was pronounced to be practicable, both by this body of administrative experts and by the committee to which it was presented. It is interesting to note, however, that as actually formulated the tax became, not a levy on capital or wealth in the sense that its original advocates had conceived such a levy, but a fairly heavy, special income tax, the basis of which was to be the amount of increase of wealth between 1914 and 1919. The Board of Inland Revenue demonstrated at great length that in all but a few exceptional cases the tax, which was to be paid in ten annual installments, could be paid from income without seriously affecting investments, the banks or business in general. In this form the proposal became a hybrid, property increment-income tax, assessed on the increase of property value and payable, if desired, from income. Professor Pigou's attack rested on the hypothesis that continuing heavy income taxation would check economic activity more seriously than the outright capital levy. By this line of reasoning, however, the plan as it was proposed stood condemned, since it resolved itself into an unusually heavy income taxation over a ten-year period.

The latest proposal was that of a minority of the Committee on National Debt and Taxation (the so-called Colwyn Committee) in 1927. This minority approved the capital levy in principle, but suggested, as an alternative, a special surtax on investment incomes for the purposes of debt redemption. The substitution of surtax for capital levy was endorsed by the Labor Party in 1927, but this has apparently been the end of it.¹⁵ The depression took a heavy toll of capital values, and there is no current interest in a capital levy anywhere.

A similar shift in the line of thought seems to have occurred in Germany. There it was urged that property owed a special obligation to the Fatherland, and the contribution was defended as a sacrifice rather than as either a tax or a confiscation by the state.¹⁶ The German law of 1919 carried a long list of complete exemptions, together with personal deductions, special discrimination in favor of agricultural property, steeply graduated rates and an arrangement for payment in installments covering a long period of years.

Virtually all of the capital levy schemes that have been actually introduced have, like those of Germany and England, taken the form of a special installment tax which is expected to be paid, in the majority of cases, from income. This change, together with the other significant one

¹⁵ A. Comstock, "From Capital Levy to Surtax," *American Economic Review*, Vol. XVIII, p. 9 (March, 1928).

¹⁶ J. Jastrow, "The German Capital Levy Tax," *Quarterly Journal of Economics*, Vol. XXXIV, p. 462 (May, 1920).

of restricting it to the increase of wealth that occurred during the war, removes the tax from the category of a capital levy and places it in the list of war profits taxes, of which it becomes a variant. No simon-pure levy on capital has actually been introduced anywhere.

REFUNDING AND CONVERSION

One other aspect of debt management must be considered. This is the procedure to be followed in the event that matured debt cannot be redeemed on the due date. An undesirable and disagreeable option is default, and a still more disagreeable one is repudiation. But these are measures of desperation. The honorable alternative, for the public as for the private debtor who is unable to pay at maturity, is to seek an extension of the loan. In public financing such an extension of a matured debt is called *refunding*. Another procedure that involves changes of debt terms is *conversion*. The two are not identical, although there is some tendency to confuse them.

Refunding. In the sense used here, a debt is refunded when an extension of payment is arranged for matured or almost matured obligations that cannot be redeemed. Naturally there is an issue of new or different bonds or pieces of paper, for those that have matured have no more interest coupons attached and they expressly provide for payment on a certain date. In theory the creditors grant the extension, but in practice only those former holders who are satisfied to continue their investment accept an exchange. The remainder of the refunding issue is sold and the proceeds are used to take up the matured bonds from those who prefer to have cash.

Refunding is frequently and properly employed by private corporations which regard their bonds as representing a portion of the capital permanently employed in the business. New bonds are exchanged for old, or are sold to other investors and the proceeds used to redeem maturing obligations in cash. Thus there is a periodic settlement with creditors and a formal discharge of the debt obligation. Public debt representing capital invested in reproductive commercial enterprises may properly be refunded in the same way, subject to the qualification noted above regarding the conservation of the capital values represented by the bonds.

The general practice of refunding becomes objectionable when applied to the mass of public debt that has been issued for non-reproductive purposes. Complete freedom to refund, and a general exercise of this privilege, would mean in effect a perpetual debt, notwithstanding the formal use of maturity dates. The practice of borrowing to finance the construction of improvements, such as roads, schools, sewers, and the like, requires that the debt be redeemed within the life of the improvement. Otherwise, its replacement will involve a new debt while that for

the worn-out property or equipment is still unpaid. Extensive refunding is likely to mean pyramiding of debt.

The state legislation providing for serial maturities usually forbids refunding, and rightly so, since this will be unnecessary if the several successive installments have been paid as they mature. It will also be unnecessary in the case of sinking fund bonds, provided the accumulations to the sinking fund have been properly made. The necessity of refunding indicates either slackness of sinking fund management or the occurrence of some emergency that makes amortization payments impossible. During the depression there was a general easing of the restrictions on refunding as the only way of lessening the large volume of defaults.

Conversion. As used here the term *conversion* means an adjustment in the burden of interest on debt by some process of substitution. Conversion and refunding are alike in that both involve a substitution of new for old pieces of paper, and also in that in each case there may be a change in the interest rate or in some other terms of the debt contract. Under sufficiently favorable circumstances a refunding issue may carry a lower interest rate than the old bonds, but the reverse is more likely to be true, since refunding usually occurs when the debtor unit is in restricted financial circumstances and hence unable to drive a good bargain in the money market.

Conversion is more appropriately used to describe the changes that may be made in the terms of a perpetual debt. There is no question of asking for an extension of the period, since the debt never matures. Rather, it is a question of finding a sufficiently favorable market conjuncture to warrant the government in proposing to the holders of its debt that they accept an exchange of debt evidences whereby the interest charge is reduced. Technically, the government redeems the old debt and issues simultaneously an equivalent amount of new debt bearing a lower rate of interest. Except as blocks of the old debt were originally issued with a stipulation that they should not be called for redemption for a certain period, the government has the privilege of calling its debt to be redeemed, but this would be an empty gesture unless there were assurance that the new debt could be advantageously sold. The following conditions for a successful conversion are suggested both by Bastable and Allix:¹⁷

1. It is usually necessary for the price of the debt to be above par. Conversion then means that the new nominal interest is harmonized with the actual yield of the debt securities.
2. The higher the original rate of interest the more room there is in which to operate the plan. This is a strong argument against the original issue of the debt at a low rate of interest and at a discount.

¹⁷ E. Allix, *op. cit.*, pp. 920, 921.

3. The capital of the debt should not be increased, and there should usually be a guaranty against further attempts at conversion for a period of years.

4. The most propitious time is at the beginning of a period of prosperity, when investment funds are relatively abundant and interest rates are low.

As the term is used abroad, the conversion privilege is exercised by the government. In the sale of Liberty bonds, the federal government extended to the purchasers, as one of the inducements in selling bonds at a low rate of interest, a conversion privilege whereby they were permitted to exchange low-rate bonds for any subsequently issued at a higher rate. This was simply a roundabout way of guaranteeing the same ultimate rate of interest to all investors, and not a true conversion.

CHAPTER XXXII

Federal Debt Problems and Policies

THE POLICIES AND problems of debt management presented by the debt of the United States constitute too vast and intricate a subject to be dealt with here in other than outline fashion. The purpose of this chapter is to indicate the way in which some of the general principles of public credit and of debt administration have been applied in the case of the federal debt. The account will deal principally with the operations during the first World War and the interval between that war and the second World War. Some of the policies applied in this period had their roots in the earlier development of debt theory and practice, but in the main, the contribution of the earlier federal debt history is of a negative sort. It indicates various things that should not be done in the flotation and redemption of public debt. The problems encountered and the solutions adopted in federal debt management since 1914 are sufficiently varied in scope to provide a fairly complete basis of judgment as to the elements of good policy.

COMPOSITION OF THE FEDERAL DEBT IN 1914

The federal debt situation as of June 30, 1914, on the eve of the first World War, was very favorable. The total interest-bearing debt was relatively small, the interest cost was moderate, and the maturities offered no difficulties for the future. The composition and terms of the debt on that date are shown in Table XLVI.

The purposes of these issues may be briefly indicated, although in some cases it is already clear. The largest category consisted of the Consols of 1930. These had been issued in 1900, as a means of refunding various remnants of the Civil War debt that were due to mature in the early years of the twentieth century. Refunding was necessary for part of the total, as the federal tax system of that day could not have produced easily a sufficient surplus of revenue to manage the whole. It was advantageous to refund the entire amount for a fairly long term, since the maturing bonds carried the circulation privilege, that is, they were eligible to be deposited with the Treasury as collateral security for national bank notes. Their redemption, had this been possible, would have

compelled authorization of other securities as collateral for the retirement of the national banknotes. Gold was of course acceptable as collateral, but it is doubtful if the banks would have been willing to tie up metal as note coverage on a large scale. The Consols were given the circulation privilege, which accounts for the low interest rate, since the banks had no option but to accept them on the terms proposed or give up the privilege of banknote issue.

TABLE XLVI

COMPOSITION AND TERMS OF THE INTEREST-BEARING FEDERAL DEBT OUTSTANDING
ON JUNE 30, 1914

<i>Purpose of Loan</i>	<i>Interest Rate Per Cent</i>	<i>Redeemable</i>	<i>National Bank Note Circulation Privilege</i>	<i>Amount Outstand- ing</i>
Consols	2	After April 1, 1930	yes	\$646,250,150
	2	After August 1, 1916	yes	54,631,980
Panama Canal	2	After November 1, 1918	yes	30,000,000
	3	June 1, 1961	no	50,000,000
Gold purchase bonds	4	February 1, 1961	no	118,489,900
Spanish War loan	3	After August 1, 1918	no	63,945,460
Postal savings	2½	One year after date	no	4,635,820
Total interest-bearing debt				\$967,935,310

The purpose of the Panama Canal and the Spanish War loans is self-evident. The gold purchase bonds of 1895 were issued to a banking syndicate formed in that year at the solicitation of the government, to import gold for the Treasury in order to avoid suspension of Greenback redemption in gold.

The Postal Savings bonds were first authorized in 1910, to be issued to any postal savings depositor who desired to exchange his deposit for such bonds. Each annual series was to mature in twenty years, but was redeemable after one year at the option of the government.

In addition to the interest-bearing debt, the Treasury carried as liabilities a small amount of old debt on which interest had ceased but which had not yet been presented for redemption; and also the various currency issues which it was obligated to redeem either in gold or silver.¹ While these constituted treasury obligations, they were a different sort of debt altogether from the interest-bearing debt and will not be further considered in this discussion. Against much of this type of indebtedness metallic reserves to the full amount were held, as in the case of the gold and silver certificates. The subject assumes importance in connection with

¹ The silver certificates and the treasury notes of 1890 were redeemable in silver.

public debt only when a large quantity of such paper currency is issued without reserve backing and without the obligation to maintain its exchange value at a parity with the metallic currency standard.

COMPOSITION OF THE DEBT ON AUGUST 31, 1919

Five years and two months after the date of the federal debt statement shown above, on August 31, 1919, the interest-bearing debt stood at its peak following the first World War financing. Its composition after giving effect to the war loans is shown in Table XLVII.

TABLE XLVII
COMPOSITION OF THE FEDERAL INTEREST-BEARING DEBT ON AUGUST 31, 1919
(THOUSANDS OF DOLLARS)

<i>Form of Debt</i>	<i>Amount</i>
Pre-war debt	\$ 883,463
Liberty loans	16,219,399
Victory loan	4,113,405
Loan and tax certificates	3,938,295
Special certificates	262,914
War saving certificates	931,302
Total	<hr/> \$26,348,778

The transformation in the federal debt situation between 1914 and 1919 was great enough to shock anyone who could appreciate the essentials of sound financial policy. It was only one aspect, however, of the amazing economic and social revolution caused by the war. For the present purpose it was the important result of the war. The figures themselves are sufficiently impressive, but the comparative increase can be visualized better by noting that in the fiscal year 1920, in which the debt reached its peak, the interest exceeded the whole amount of the interest-bearing debt outstanding on June 30, 1914.² Moreover, the problem of management, in August, 1919, had been enlarged to difficult, if not terrifying proportions, for all of the certificates, aggregating more than \$4,200,000,000, were due within one year or less, the whole of the Victory loan was due inside of four years, and the war savings certificates were all due within five years. Counting as short-term debt all with a maturity of five years or less, the total in August, 1919, was more than \$9,000,000,000.

Looking back over this period now, it is possible to say that these extremely difficult problems were adequately dealt with, and that by June 30, 1930, the interest-bearing debt had been reduced to \$15,921,892,000. The technique by which this was accomplished will presently

² The interest for the fiscal year 1920 was \$1,120,252,000.

be indicated. Before proceeding to this subject, however, some matters of method and policy in issuing the war loans deserve explanation and comment.

THE TECHNIQUE AND POLICY OF WAR BORROWING

The United States entered the war on April 6, 1917. Prior to that date, therefore, no legislative nor administrative steps were taken in open and active preparation for war, since a definite policy of neutrality had been maintained. Consequently, the machinery for financing the war activity had to be designed, legislated into existence and tuned to smooth operation after war was declared. Borrowing was obviously necessary, for large expenditures had to be made immediately and tax increases, even if enacted at once, would gather momentum slowly. The income tax was in operation, but its yield could not be increased short of a year. Moreover, there was at that time no support, from tax theorists or political leaders, for broadly based excise or consumption taxes, such as a general sales tax, which would have produced substantial revenue within a short time. The first war tax law was approved on October 3, 1917, and the first liberty loan act, although enacted on April 24, 1917, did not produce the first installment of the subscriptions thereto until June 28.

Short-term anticipatory borrowing. The financial emergency was met by short-term loans. This is a familiar and perfectly proper device, when correctly used. It had been used extensively during the Civil War, and the mistakes of that period indicated clearly the dangers to be avoided. The most serious error is over-reliance on short-term or temporary debt, for it then becomes necessary to arrange for its refunding while at the same time endeavoring to float new loans.³ The successive war loan acts placed a sufficient emphasis on long-term borrowing to assure that with proper management there would be no risk of falling into this pit.

The loan anticipation certificate. The short-term instrument used was the treasury certificate. It was issued for two major purposes, the anticipation of permanent loan subscriptions and the anticipation of tax payments. The loan certificate technique may be illustrated, in the case of the first loan, by the data in Table XLVIII.

³ The proportion of short- and long-term loans during the Civil War was as follows:

<i>Fiscal Year</i>	<i>Long Term</i>	<i>Short Term</i>
1861-62	15 per cent	85 per cent
1862-63	29 " "	71 " "
1863-64	67 " "	33 " "
1864-65	39 " "	61 " "

D. R. Dewey, *Financial History of the United States*, p. 317.

TABLE XLVIII
FIRST LIBERTY LOAN ANTICIPATION CERTIFICATES

<i>Date of Issue</i>	<i>Per Cent of Interest Rate</i>	<i>Date of Maturity</i>	<i>Amount</i>
April 25, 1917	3	June 29, 1917	\$268,205,000
May 10, 1917	3	July 17, 1917	200,000,000
May 25, 1917	3¼	July 30, 1917	200,000,000
June 8, 1917	3¼	July 30, 1917	200,000,000
Total			\$868,205,000

According to the terms of issue these certificates were receivable in payment of subscriptions to the first loan. The first installment of this loan was due June 28, 1917, the day before the first of the certificate issues matured. All of these certificates were either exchanged for first loan bonds or were redeemed at maturity in cash from the proceeds of the loan, and the Treasury had the remainder of the loan as a cash working balance. In like manner the flotation of the successive war loans was preceded by the issue of loan anticipation certificates, which were in turn retired through the exchange for bonds or for cash realized from the sale of the bonds. The amount of certificates outstanding on the several dates on which the first installments of loan subscription were due is shown in Table XLIX.⁴

TABLE XLIX
TOTAL CERTIFICATE OPERATIONS FOR THE SUCCESSIVE LIBERTY LOANS
(THOUSANDS OF DOLLARS)

<i>Liberty Loan</i>	<i>Due Date of First Installment</i>	<i>Amount of Loan</i>	<i>Certificates Outstanding</i>	<i>Ratio of Certificates to Loan</i>
First	June 28, 1917	\$2,000,000	\$ 868,205	43.4
Second	Nov. 15, 1917	3,808,766	2,320,493	60.9
Third	May 4, 1918	4,170,020	2,612,085	62.6
Fourth	Oct. 19, 1918	6,989,047	4,665,320	66.7
Fifth	May 10, 1919	4,498,312	5,544,151	123.2

It will be observed that as the war progressed and the financial burden increased, steadily larger proportions of the proceeds of the successive loans were collected and spent in advance, through the issue of loan anticipation certificates, until in the case of the victory loan, six months after the Armistice, much more than the whole loan had been so spent

⁴ Cf. J. Hollander, *War Borrowing*, p. 59, and Secretary of the Treasury, *Report*, 1919.

before any payments were due to be made on the subscriptions to this loan. In the financial sense the war did not end with the Armistice. This situation, which necessitated the refunding of a part of the victory loan anticipation certificates, was less serious at that stage than it would have been earlier in the conflict, and it was accomplished without embarrassment to the government's credit.

The tax anticipation certificates. In a similar way the collections of income and profits taxes were anticipated by temporary borrowing. The tax certificate was a great convenience to the large taxpayer, who was enabled, through the purchase of certificates from time to time as funds accumulated, to prepare for his heavy tax settlements. In reality, the tax was thus paid in advance, and the taxpayer received interest on this advance to the government at the rate borne by the tax certificates. Tax settlement on the quarterly due dates became, for the holders of certificates, simply a process of surrendering the certificates that had been bought weeks or months previously. The announcement was made in 1922 that, in view of the large income and profits tax payments, it would be desirable to have at all times at least \$1,000,000,000 of tax certificates outstanding, in amounts and maturities corresponding to the quarterly tax payments.⁵ No attempt was made, however, to maintain the volume of such certificates outstanding at a level above that required by the convenience of the treasury.

Special certificates. The certificate device was used extensively for various special purposes, such as the anticipation of funds transferred or remitted from one part of the country to another, the establishment of credits abroad, and the like. Although the aggregate turnover was large, the maturities were always short, often not more than a few days, and the volume at any one time did not materially influence the debt situation.

The chief component in the total of special certificates shown in Table XLVII were the so-called Pittman Act certificates. This act was enacted in 1918 to relieve the foreign exchange situation with certain silver standard countries, and incidentally to provide a subsidy for domestic silver mines. It authorized the sale of domestic silver at the rate of \$1.00 per ounce. India and China were exporting large quantities of raw materials, and England thus obtained the means of settling her trade balance with these countries. As silver was withdrawn a corresponding amount of silver certificate currency was cancelled, and to prevent currency contraction the reserve banks were authorized to issue federal reserve banknotes secured by treasury certificates of indebtedness. The silver thus disposed of was to be replaced later from the domestic mine output, at the same price, and as this occurred the reserve banknotes were to be retired and the certificates of indebtedness redeemed and cancelled.

⁵ Circular letter addressed to the federal reserve banks, October 9, 1922. Cf. *Report of the Secretary of the Treasury*, 1922, p. 172.

War savings certificates. The financial pressure of the war led to various methods of appealing to the people for funds. One of the most effective of these was the war savings certificate, which was introduced into this country by the second loan act. It had already been used in England. This certificate was designed to catch the loose change that is ordinarily spent heedlessly, and to enable those who could not buy even the "baby bond" of \$50 denomination to have some part in the war financing. Adhesive stamps of twenty-five cent denomination could be accumulated and eventually exchanged for a savings certificate of \$5.00 face value maturing in five years, at a price which represented about $4\frac{1}{2}$ per cent compound interest. There was vigorous popular coöperation with the Treasury in the sale of these certificates, and the maximum amount outstanding was \$1,013,000,000 on January 31, 1919. They probably represented, in large part, genuine savings, and in this respect they were in accord with sound principles of credit financing.

In the beginning it was thought that this type of certificate would become a more or less permanent feature of the debt structure, giving the people at large a share in the public loans and affording at the same time a valuable object lesson in habits of thrift. A nationwide selling organization was projected to establish contacts with labor and fraternal organizations, women's clubs and the public schools.

The whole movement was later abandoned in the face of some banking opposition. The savings bond device was reintroduced in 1935, with some modifications. A succession of issues, distinguished by the letters *A*, *B*, *C*, etc., were sold on a discount basis, maturing in ten years and yielding 2.90 per cent to maturity. They were redeemable on demand at any time after 60 days from the issue date, but at reduced terms of interest yield. A limit of \$10,000 maturity value was set for a given year's purchase by any owner. Series *A* through *D* could be held by individuals, corporations or other organizations and the interest thereon was exempt from normal tax. The bonds were non-marketable and could not be used as security for a loan.⁶

Three new series of savings bonds, designated as *E*, *F*, and *G*, were introduced on May 1, 1941, and sale of all previous series was discontinued. Series *E* and *F* were sold on a discount basis, for maturities of 10 and 12 years, and yielding to maturity 2.90 per cent and 2.53 per cent, respectively. Purchases of Series *E* were limited to \$5,000 maturity value in one year, and of Series *F* and *G*, singly or in combination, to a total issue price of \$50,000. Series *G* was a coupon bond, sold at par, bearing $2\frac{1}{2}$ per cent, due in 12 years. Both individuals and incorporated or unincorporated bodies, except commercial banks, were permitted to buy Series *F* and *G* bonds. Sales of Series *E* bonds were restricted to individ-

⁶ Treasury Circular No. 530, "Public Debt," in *Report of the Secretary of the Treasury*, 1936, pp. 247-253.

uals. None of these bonds was transferable and the interest was fully taxable.⁷

These bonds, particularly the Series *E* bond, became important instruments in financing the second World War costs. A general program of regular purchase through payroll deduction was instituted, and savings stamps were again resorted to as an aid to the accumulation of loose change in amounts sufficient to purchase a savings bond.

The policies of war borrowing. The technical devices for issuing a large mass of debt obligations were well handled during the first World War, and their subsequent manipulation, both in the redemption of the twenties and the subsequent expansion of the depression period, was effective. With respect to some matters of policy, however, a different verdict must be given. Many important aspects of policy have always been determined mainly on the basis of political expediency, which means that the government's best financial interest has not always been considered. One writer, after reviewing the whole course of federal finance, concludes: ⁸

In not a single major period in American finance has the Treasury manipulated matters so as to avoid the unfortunate confusion and the costly results which follow in the wake of badly used financing tactics. The misuse of both security features and financing devices may accordingly be described as characteristic of American financing.

Some instances of the concession to expediency during the first World War may be briefly mentioned.

The interest rate. The error of setting the interest rate too low, while at the same time requiring that bonds be sold at par, has often been made. It hampered the sale of bonds during the Civil War,⁹ and it led the administration to rely on other features to make the liberty bonds attractive. It also compelled the sales appeal to be made on the basis of patriotism, always a dubious basis of financial support, and as it weakened, the Treasury was forced to use part of the proceeds of each loan to support the market for earlier issues, lest the weakness of its policy become too apparent.

The principal forms of bait used to tempt investors to accept a low interest rate were conversion and tax exemption. Buyers of the first loan, bearing 3½ per cent interest, were assured complete tax exemption and the privilege of converting their bonds into any later issue bearing a

⁷ Treasury Department Circulars Nos. 653 and 654, "Public Debt," in *Report of the Secretary of the Treasury*, 1941, pp. 304-314.

⁸ R. A. Love, *Federal Financing, A Study of the Methods Employed by the Treasury in its Borrowing Operations* (1931), p. 240.

⁹ D. R. Dewey, *op. cit.*, pp. 310, 311, quotes Secretary Chase as saying that \$400,000,000 of Greenbacks were required to float a 6 per cent issue at par, and that it would probably require still further currency inflation to persuade the people to accept a 5 per cent issue.

higher rate. Only a small part of this loan was actually converted, as the tax exemption privilege proved too valuable to be relinquished; but the 4 per cent bonds of the second loan were converted to $4\frac{1}{2}$ per cent bonds on a large scale. The treasury advantage from the conversion feature was but temporary.

Tax exemption. The tax exemption feature was of greater importance. In fact, it grew in significance, with the great expansion of the federal debt and the heavy increase of income tax rates. In extenuation it might be said that when the policy was inaugurated there was but little indication of the tremendous tax rate increase that lay ahead, and that it was a customary policy for all governments to exempt their own bonds. The exemption feature was stressed in appealing to small as well as to large investors, however, and thus it was clear that the privilege was regarded as part of the patriotic appeal. In later bond issues the tax exemption privilege was limited to the normal tax, with additional surtax exemption with respect to interest from limited amounts of principal only. This amount is now \$5,000. Tax exemption of interest in federal obligations was entirely eliminated as to all debt issued after March 1, 1941.

The 5 per cent purchase fund. As the successive issues appeared, greater difficulty was encountered in selling them, despite the increase of the advertising appropriation from $\frac{1}{10}$ to $\frac{1}{5}$ per cent of the proceeds. The duration of the conversion privilege was also restricted. Nevertheless, it was deemed necessary as the third loan act was passed to authorize the use of not more than 5 per cent of the proceeds for the purchase of bonds in the market, the obvious purpose being to support the price and thus lessen the difficulty of placing the new issues. The war finance corporation later continued this policy. To June 30, 1920, a total of \$1,746,-944,000 of securities had been purchased.¹⁰

Bonds bearing interest at more than 4 per cent were made receivable in settlement of estate or inheritance taxes, if owned and held by the decedent for at least six months prior to his death. Foreign governments were also permitted to tender the bonds at par in settlement of their indebtedness to the United States. The banks were requested, and later virtually commanded, to lend to any subscriber at the coupon rate of the bonds. Large numbers of special depository banks were established, with the privilege of carrying as a deposit credit for a longer or shorter time the proceeds of the bonds bought by them.

¹⁰ Data from Love, *op. cit.*, p. 160. In 1918 the Secretary of the Treasury defended the patriotic appeal by saying: "...the price of liberty bonds, even though quoted at less than par on the exchanges, would not deter the American people from buying at par the same bonds when offered by their government to secure the necessary funds to carry on the war; that the patriotism of the American people was not measured by interest rates nor determined by the fluctuations in the market price of government bonds on the stock exchange." *Annual Report*, 1918, p. 6.

Finally, in arranging the terms of the fifth or victory loan, the obvious necessity of some further adjustment of interest rate was encountered, and to avoid the demand from holders of former issues for the right to convert these issues, the device was hit upon of calling the new issue notes instead of bonds, thus automatically barring conversion, since that privilege had been authorized only with respect to future bond issues.¹¹

REDEMPTION AND REORGANIZATION OF THE DEBT, 1919-1930

The problem of federal debt management in the years following the war involved chiefly the reorganization of the structure so as to permit redemption where possible and refunding to the extent that this was necessary. The two major matters that call for brief attention here are the technique of debt reorganization and the sources of the funds for redemption.

The technique of debt reorganization. The essential task that confronted the Treasury as the debt stood at its peak in August, 1919, was that of dealing with the short-term debt, which then included the whole of the victory loan, together with a large mass of temporary certificates. It was necessary to resort to certificate refunding, but no difficulty arose since the government was not at the same time seeking fresh supplies of funds. By means of refunding and redemption the first year or so was successfully passed, and the next move, made as a preliminary to the attack on the problem of the victory loan, was the introduction of the treasury note.

The treasury note. The treasury note is an obligation having a maturity of three to five years. It is thus a useful intermediate between the certificate, maturing in one year or less, and the long-term bond, for it provides a means of breaking up a large mass of paper into installments of more moderate size, each of which can be dealt with either by redemption or by further refunding. The first issue of treasury notes was made in June, 1921, and the effectiveness of this loan form during the next few years may be seen from the changes in the volume and composition of the short-term debt between August, 1919, and June, 1923. This contrast is given in Table L.

The interesting and significant point to be emphasized in this comparison is the virtual substitution of treasury notes for the victory notes. It did not happen exactly so, of course, for some of the latter were redeemed outright, and some are represented by the first of the post-war long-term loans, the treasury bonds of 1947-1952. The funds available for debt redemption during these years made the task easier, but it remains, nevertheless, a notable achievement in debt management.

¹¹ Love, *op. cit.*, p. 187.

TABLE L
CHANGES IN SHORT-TERM DEBT 1919 TO 1923
(MILLIONS OF DOLLARS)

<i>Form of Debt</i>	<i>Amount Out- standing August 31, 1919</i>	<i>Amount Out- standing June 30, 1923</i>
Victory notes	\$4,114	...
Loan and tax certificates	3,938	\$1,132
War savings certificates	932	337
Other special certificates	263	...
Treasury notes	...	4,104
Total short-term debt	\$9,247	\$5,473
Treasury bonds, 1947-52	...	764
Total interest-bearing debt	26,349	22,008

The technique thus tested and developed was subsequently used in managing the federal debt. It was necessary to postpone a substantial proportion of the successive liberty loan issues by refunding, and these refunding loans, together with the large amount of fresh borrowing that has occurred since 1930, cause the future to bristle with federal debt maturity dates.

The treasury bill. In 1929 Congress authorized the use of the treasury bill, an adaptation of a financial device long familiar throughout the commercial world. It had also been used for many years by the English treasury. The bill is drawn by the Treasury on itself and is discounted in the open market. At maturity the face value is paid, the difference between the discounted or sale price and the par value being the interest cost of the loan. The advantage of the bill over the treasury certificate is that it puts the burden of determining the correct current interest rate from the Treasury over upon the bill market. The bill has become an important feature of federal short-term operations, and the competition of surplus bank funds has enabled the Treasury to realize extremely advantageous terms. On a few occasions, and for reasons connected with the exigencies of the banking situation, bills were sold at a premium, indicating negative interest to the holders.

Sources of the funds for debt redemption. The sources of the funds for debt redemption during the fiscal years 1920 to 1930, when the net total of the debt was actually declining, are shown in Table LI, together with the amount provided by each source.

This record of debt redemption is unsurpassed in the annals of public finance. The nature of the several sources of the funds used is clear enough from the data given in the table, but in some cases certain further details should be provided.

TABLE LI

SOURCES OF FUNDS FOR DEBT REDEMPTION FISCAL YEARS 1920-1930
(THOUSANDS OF DOLLARS)

Sinking fund	\$3,187,468
Payments from foreign governments	
cash	376,904
bonds and notes	1,111,815
Bonds and notes in settlement of estate taxes	66,182
Reserve bank franchise taxes	149,030
Surplus revenue receipts	3,459,507
Net decrease of general fund balance	933,067
Miscellaneous	15,224
Total debt reduction	\$9,299,197

The sinking fund. The earliest federal experience with a sinking fund has already been mentioned in the preceding chapter. During the Civil War a sinking fund was again established. The law provided that the gold coin received as duties on imports, after satisfying all interest on the public debt, should be applied to the annual purchase or redemption of 1 per cent of the entire debt. The interest on the debt purchased was also to be so used. Dewey states that no attempt was made to observe this provision during the war, and that it was not regarded as binding afterwards, although Hugh McCulloch, as Secretary of the Treasury, observed the spirit of the law by buying bonds and canceling them outright whenever surplus revenues permitted.¹²

The funding act of 1870 eliminated the use of interest on redeemed bonds for further redemption by ordering these bonds to be destroyed, but retained the principle of annual purchase. The observance of this principle varied with different treasury administrations and with the government's financial condition. While bonds were being issued for gold in anticipation of specie resumption in 1879, for example, no redemption of bonds in gold was undertaken. A decade later extravagant premiums were paid for the bonds redeemed, as one means of disposing of the troublesome treasury surplus. On the whole, the redemption of the Civil War bonds proceeded rapidly, and the spirit of the sinking fund policy was more than fully complied with, in all probability.

The enormous addition to the debt during the first World War led to a revision of the sinking fund policy. Section 6 of the Victory Loan Act repealed the old sinking fund measures, and provided in lieu thereof that for each fiscal year beginning with July 1, 1920, an amount should be set aside for debt redemption equal to (1) 2½ per cent of the bonds and notes outstanding, less the par amount of foreign government obligations held by the United States, on July 1, 1920, and (2) the interest that would have been payable during the year on the bonds and notes pur-

¹² D. R. Dewey, *op. cit.*, p. 356.

chased, redeemed or paid out of the sinking fund during the year or in previous years.

The original sinking fund act authorized the use of the fund only for the redemption of bonds and notes issued under the war loan acts and outstanding on July 1, 1920. An amendment of 1923 permitted the use of these appropriations for the redemption of refunding bonds and notes as well as for the retirement of the original debt obligations. The gold reserve act of 1934 eliminated the reference to refunding and thus broadened the sinking fund to cover all outstanding debt, for whatever purpose issued. The National Industrial Recovery Act also broadened the sinking fund plan by requiring, for the fiscal year 1934 and thereafter, an appropriation to the fund of 2½ per cent of the aggregate expenditure made under the public works title of that act. While the budget was unbalanced, this, like the whole sinking fund scheme, was only a gesture.

The sinking fund is referred to as cumulative, an effect that is produced by adding to the fixed annual appropriation an amount equivalent to the interest on all debt retired by the previous sinking fund operations. Such appears to have been the intent of the law. A technical question arises as to the obligation to continue appropriations on account of interest after the maturity of particular issues that have been acquired by the fund. This raises the whole question of the efficacy of such legislation.¹³ No sinking fund is actually effective as a medium of debt retirement unless the budget can provide a revenue surplus sufficient to cover the annual requirements of the fund. When this is possible, it is, in general, advantageous to let the fund grow as rapidly as possible. If sufficient revenue is not available, the sinking fund operations do not reduce the debt.

An illustration of the latter point has been provided by the situation since 1930. Appropriations to the sinking fund were maintained, despite the current revenue deficit, which meant, in effect, that the government was borrowing the money appropriated to the sinking fund for the redemption of debt. There was no alternative, since the law requiring it continued in effect. The procedure may have been tactically beneficial, although it could have no practical effect on the debt situation. The presence of the sinking fund appropriation in each annual budget emphasized the revenue deficit and the debt problem. Given some concern for sound fiscal policy, the maintenance of sinking fund provisions during a deficit period could have some restraining influence on the volume of new borrowing, which, without this reminder, could be even greater than otherwise.¹⁴

Foreign debt payments. As noted above, foreign governments were authorized to tender federal securities at par in settlement of their debt,

¹³ Cf. H. G. Hendricks, *The Federal Debt* (1933), pp. 221, 222.

¹⁴ Cf. The Committee on Postwar Tax Policy, *A Tax Program for a Solvent America*, New York, 1945, p. 24.

and this was a profitable way of making payment as long as bonds or notes could be acquired in the market below that figure. The entire scheme of reparations and inter-allied debt payment collapsed shortly after 1930, except in the case of Finland. It involved issues of national policy extending beyond the specific problem of debt payment. These are dealt with later in this chapter.

Estate tax payments. The privilege of tendering treasury notes and bonds in settlement of estate taxes during the period under review was limited to issues bearing interest at a rate higher than 4 per cent. In 1942 this privilege was introduced as a feature of the offering of 2½ per cent bonds of 1962-67. The use of eligible securities to settle estate taxes is conditioned, in practice, on the price at which they are quoted at the time the estate is appraised. If they are worth more than par in the market no administrator of an estate would deliver them to the government at par in payment of the tax.

Other funds. The remaining sources of funds include the federal government's share of the net earnings of the federal reserve and federal intermediate credit banks, the surplus revenues, and the general fund cash balances. The bank earnings taken by the Treasury are regarded, by the law, as franchise taxes on the respective banks. The prosperous twenties produced substantial surplus revenues, despite the reductions in the rates and scope of federal taxation. This is one aspect of that period that is often overlooked by those who hope that its like may never occur again. The general fund balance was maintained at a high level during the war, in conformity with the unusual requirements for working cash. The principal contribution to debt retirement from this source occurred in the year immediately afterward when the balance was reduced to a level commensurate with normal operating needs.

DEBT PROBLEMS OF DEPRESSION AND RECOVERY

The course of federal expenditure, and the theory that underlay the policy followed during the depression years of the early thirties, have already been reviewed. The result of expanding expenditure and receding revenue was a rapid increase of the federal debt. It is customary to look back on the period preceding the economic collapse of 1929 with disdain, if not with contempt. It should be clear, however, that the remarkable achievement of that period, in establishing an effective technique of debt management and in actually redeeming more than \$9,000,000,000, was a service of inestimable value for the depression years. Some governmental policies of those earlier years may have contributed to the force of the depression; but the earlier vigorous debt policy strengthened enormously the federal government's financial capacity to meet the emergency.

This discussion cannot enter upon the question of policy involved in

the federal program that led to the debt increase after 1930. The facts will be registered, and some matters of debt management will be considered.

The increase of debt. On June 30, 1930, the interest-bearing debt stood at \$15,921,892,000. At the close of the fiscal year 1940 it was \$42,380,000,000. The second World War began in September, 1939, and by the following summer it was clear that large preparations for national defense were imperative. The war began, for the United States, on December 7, 1941. Its cost made all previous experiences seem relatively insignificant. As of June 30, 1946, the total interest-bearing debt was \$268.1 billion. Likewise, the problems of debt management which lie ahead will be far more serious and difficult than any that were presented by the first World War debt, impressive as those appeared to be at the time. It will be possible in this chapter only to indicate some of the more significant aspects of post-war debt management.

Debt management, 1930-1940. The federal debt rose continuously through the period 1930 to 1940. Emphasis in debt management shifted, therefore, from retirement to expansion. The growth of the debt was facilitated by the existence of an easy money market, in which the ordinary principle of price in relation to demand and supply appeared to be suspended, for the ever increasing quantity of federal paper commanded ever-better terms. The suspension was illusory only, for there was a waxing dearth of private loan paper, a plethora of loanable bank funds, and a steady extension of governmental influence over the banking system. The federal debt became the principal investment form and the pressure to find any sort of income-producing use for the excess funds led to a sufficient competition for the successive debt issues to sustain, even to advance their price, in face of the expanding total.

For example, the computed annual interest charge on the interest-bearing debt for the fiscal year 1930 was 3.807 per cent. The highest previous figure since 1916 had been 4.339 per cent in 1920. As of June, 1940, this average interest charge had fallen to 2.583 per cent. The explanation lies in the steadily lower rates at which new debt was issued, both for the current spending program and for the refunding of the older, high-rate issues. Despite this marked decline in the interest rates, the rising prices of federal bonds are indicated by the course of the yield from such investments. The average return on long-term treasury bonds for the calendar year 1930 was 3.290 per cent. For the first six months of 1940 it was 2.315 per cent.¹⁵

The surplus of bank funds, as a factor in this curious combination of trends, may be indicated by the volume of excess bank reserves. For the period under review the years of high and low excess reserves were as follows:

¹⁵ *Report of the Secretary of the Treasury*, 1940, p. 781.

<i>Year</i>	<i>Member Bank Excess Reserves (millions)</i>
1930	\$ 96
1931	33
1935	2,844
1937	1,212
1940	6,615

The large excess of bank reserves over the legal maximum has been distinctly a phenomenon of the 1930's and later years. Prior to that time excess reserves had always been small and at times the banks had fallen below their legal requirements, a condition which compelled readjustment either by rediscounting eligible paper with the federal reserve banks or by curtailing loans to customers. As long as member banks hovered on the edge of their legal reserve requirements, the federal reserve banks were in position to influence the volume of bank credit through adjustments of the rediscount rate and through open market operations. They did not always perform this function adequately. A notable instance of failure was in the years 1927-29, when the worst excesses in the stock market boom might have been prevented by a different central bank policy. The federal reserve banks lost control of the credit situation when the member banks, through their possession of large excess reserves, were in no need of the credit support which the central banks were established, among other things, to supply.

The principal reason for the emergence of excess reserves was the huge addition to the country's gold stocks. At the end of 1933 this gold was valued at \$4,036 million. A year later, largely as a result of the devaluation of the dollar, the gold stock was \$8,238 million. Immense shipments were received thereafter, and at its peak, at the end of 1941, the gold stock amounted to \$22,737 million.

The conjuncture of declining interest rates and firming bond prices contributed to a myopic view of the advantages of public borrowing. Coupled with the emergence of doctrines conveniently forged to establish the beneficence of public credit inflation as a factor in elevating the national income, the argument that the debt costs so little became a useful adjunct to the argument that the internal debt is no burden because we owe it to ourselves.

Under the circumstances outlined above, the conversion of the remainder of the earlier debt issues was readily carried through. These issues included the First and Fourth Liberty loans and the 2 per cent bonds with the circulation privilege. The operations involving the Liberty loans are summarized in Table LII.

The familiar technique of combining notes and bonds, with a view to splitting off a portion of the main mass, is here illustrated. At the time these refunding operations were executed, in 1934 and 1935, there was

some reason to anticipate that the notes, amounting to about 20 per cent of the total, might be paid off as they matured. The subsequent rise of an anti-redemption philosophy and the approach of the second World War prevented achievement of this goal. The cash payments recorded in the above operation were obtained from other borrowings, not from current revenue. There was no net reduction of debt. The interest savings were, however, considerable. The amount of such saving on the Fourth Loan to its maturity in 1938 was estimated to be \$267,049,000.¹⁶

TABLE LII
REFUNDING OF THE FIRST AND FOURTH LIBERTY LOANS
(MILLIONS OF DOLLARS)

	<i>First Loan</i>	<i>Fourth Loan</i>
Outstanding at first call	\$1,933.2	\$6,268.1
Exchanged for		
<i>a.</i> Treasury bonds, various maturities	746.4	4,311.9
<i>b.</i> Treasury notes	864.5	1,025.6
Total exchanged	\$1,610.9	\$5,337.5
Redeemed for cash	177.5	872.4
Balance payable on presentation	144.8	58.2
Totals	\$1,933.2	\$6,268.1

Certain other developments during this period may be briefly noted. The first is the rising proportion of short maturities. As of June 30, 1930, bonds constituted about 80 per cent of the total interest-bearing debt. In 1935, the bonds were only about 54 per cent, and in 1940, they were 60 per cent, of the interest-bearing debt. As the volume of debt expands, a certain diversity of maturities is both natural and necessary. There was, during the 1930's, a marked disposition on the part of the banks to preserve liquidity, which may have increased the preference for bills and notes over bonds. In view of the unbroken series of deficits, the liquidity provided by short-term paper was specious for the market as a whole, since the recurring redemption of bills and notes merely meant the substitution of another batch of such paper. The market could exercise no control over the total volume of floating debt of the sort that is implied by a liquid position. The interest cost of the short-term debt was, of course, less than for an equivalent principal of bonds. The political requirement to hold down the cost of the rising debt may also have played a part here.

A second development was the rise of non-marketable debt. The two main forms were the savings bonds and the special issues to government agencies and trust funds. By 1940 these classes constituted more than 18

¹⁶ *Ibid.*, 1936, p. 18.

per cent of the interest-bearing debt. The special issues to trust funds were a means of borrowing the cash receipts from the social security taxes and the cash payments to various minor trust accounts such as the civil service retirement fund and others. To this extent it was unnecessary to borrow from the general market.

A third development was the emergence of contingent debt liability through guarantee of the principal and interest of bonds and other obligations issued by various government corporations. As of June 30, 1940, the aggregate principal of such obligations was \$5,528.8 millions. While the debtor corporations continue, their maturing debt can no doubt be refunded. Only upon liquidation can there be a final determination of the extent of the government's liability. The published data do not indicate whether or not, in all cases, current interest charges are being earned in the corporate operations.

Debt management during the second World War, 1940-1945. The cost of the second World War was so enormous as to render insignificant, by comparison, the cost and the debt of the first World War. The financing task involved great dexterity in handling the various debt forms as well as vigorous efforts to expand the tax system. All of the forms of debt used had been developed and employed before. They included the treasury bill, the treasury certificate of indebtedness, treasury notes, and the treasury bonds, both marketable and non-marketable.

The manner in which these debt forms were used differed in various respects, however, from their use in the first World War. For example, loan anticipation certificates were not sold in advance of the long term offerings. In all, eight major loan campaigns were conducted without resort to anticipatory financing. Also, in relation to the volume of taxes collected, the quantity of tax anticipation certificates was much less than in the first World War. After the introduction of the current tax payment plan, in 1943, the series of such certificates designed for individual use was discontinued. A further point of difference was that large and increasing quantities of floating debt—bills and certificates—were issued and regularly refunded throughout the war period, with no evident embarrassing effects such as were encountered in the Civil War and as were feared during the first World War. The credit inflation was so fast and furious and the entire resources of the nation were so completely mobilized for the war effort, that such a matter as regular refunding of floating debt was taken in stride.

The vigorous efforts made to broaden the base of debt ownership were singularly successful. The principal instrument to this end was the Series *E* war savings bond, available in convenient denominations down to \$25 maturity value, costing \$18.75. An unremitting program of bond selling supplemented the various loan drives. It was, happily, free of the nonsense that characterized some of the loan campaigns of the first World

War.¹⁷ Regular payroll deductions for bond purchases were widespread. As of June 30, 1944, the Treasury estimated that 27,600,000 persons were participating, including private employment, government employment, and the armed forces. The total deductions for the fiscal year 1944 were \$5,546 million, which represented 9.6 per cent of the participants' pay for the year.¹⁸ The distribution of savings bonds by denomination in the fiscal years 1942-1945 inclusive was as follows:

TABLE LIII
SALES OF SAVINGS BONDS, BY SERIES, CLASSIFIED BY DENOMINATIONS, FISCAL
YEARS 1942-1945 *
(SALES IN MILLIONS OF DOLLARS AT ISSUE PRICE)

Series of Bonds	Total, all Denominations	Denominations							
		\$10 †	\$25	\$50	\$100	\$500	\$1,000	\$5,000	\$10,000
Series E	35,170.0	69.2	11,680.0	4,789.8	7,516.2	4,366.8	6,748.0	.....	...
Series F	2,674.1	..	16.3	.....	89.5	141.7	714.3	552.1	1,160.5
Series G	10,325.5	...	...	.....	329.7	773.2	3,170.8	1,920.8	4,130.9
Totals	48,169.6	69.2	11,696.3	4,789.8	7,935.4	5,281.7	10,633.1	2,472.9	5,291.4

* *Treasury Bulletin*, September, 1945, p. 44.

† Sales of \$10 denomination were authorized in June, 1944, available only to members of the armed forces.

It will be recalled that Series E and Series F bonds were sold on a discount basis, yielding to maturity 2.90 per cent and 2.53 per cent, respectively. The decided preference of buyers for the Series E bond appears explicable on the basis of this difference in yield. Substantial amounts of both Series F and Series G bonds of the highest denominations were sold because of the restriction of the maturity value of Series E bonds bought in any one year to \$5,000. The diffusion of ownership among persons with small and moderate incomes is indicated by the high proportion of the Series E bonds in the available denominations up to \$100 maturity value.

The financing of the second World War was characterized, also, by a continuance of the trend toward lower interest rates which had already become a feature of the earlier deficit financing. The principal reasons for this trend have been noted above. The golden tide moving toward our shores subsided in 1942 and by the end of 1945 the gold stock had declined from its high point by about \$2¾ billion. Meantime and as a substitute method of continuing the credit inflation, the federal reserve

¹⁷ The document, *Instructions to Minute Men*, issued in preparation for the Third Liberty Loan drive, is an excellent example of the trash put out in 1917-1918.

¹⁸ *Treasury Bulletin*, September, 1945, p. 44.

banks expanded their credit outstanding by the purchase of government debt and other paper in the market. Throughout 1941 total reserve bank credit outstanding was of the magnitude of \$2¼ billion. By the end of 1945 it was well above \$24 billion.

In the face of these conditions, it appeared good policy to take full advantage of the low and declining interest rates in the war financing. Only the future record of debt management can reveal whether or not it was wholly wise for the long run. It seems possible, however, that the low interest rate, itself a product of the credit inflation, may have contributed, in turn, to the inflation, since it estopped the loan program from siphoning off a larger portion of current income than could have been obtained at more attractive rates to individual investors. It was well understood that borrowing from individuals, out of their current income, would have no direct inflationary effect. It was also well understood that the banks had to absorb all loans not taken by non-bank investors, and the Federal Reserve Board of Governors has described its credit policy as one of supplying the banks with sufficient funds for this purpose. The data in Table LIII reveal the decided preference of the people for the highest yield savings bond. If a still better return had been offered, it seems entirely likely that a much larger quantity of such bonds would have been sold and that the purchasers would be more disposed to hold them until maturity. Patriotism plus 4 per cent would have sold many billions of savings bonds above the quantity that was sold. There would have been some increase of current interest cost for the time being, but it would have been far less in the long run than the hidden costs, present and future, of inflation.¹⁹

A principle that always deserves consideration during emergency financing is that government does not do well to haggle and squeeze over terms while the emergency is on. The time for that is in the normal period after the strain has passed. At such a time, if interest rates in a free capital market are below the level of the emergency rates, refunding and conversion will permit a downward adjustment into line with the post-war reality. On the other hand, if the emergency borrowing has been at rates forced down to rock bottom by manipulation such as credit inflation, and if these rates are destined later to rise, a difficult dilemma is presented. There must be general refunding at the higher rates, with its dangers of political repercussions, or there must be a forcible restraint of the interest rates, with its dangers for the free capital market.

The shifts in the composition of the federal debt during the second World War are shown in the following table. For this purpose the situation as of the close of the fiscal years 1941 and 1945, respectively, is selected.

¹⁹ The reader should turn again to Love's comment on Treasury policy in relation to political expediency, on p. 573, *supra*.

TABLE LIV
INTEREST-BEARING DEBT OF THE U. S. GOVERNMENT AS OF END OF FISCAL YEARS
1941 AND 1945 *
(MILLIONS OF DOLLARS)

Classification of Debt	1941		1945	
	Amount	Per Cent of Total	Amount	Per Cent of Total
I. Public issues				
A. Marketable issues				
Treasury bills	1,603	3.31	17,041	6.65
Certificates of indebtedness	....	....	34,136	13.32
Treasury notes	5,699	11.78	23,497	9.16
Treasury bonds	30,215	62.44	106,448	41.52
Other bonds	196	.41	196	.08
Total marketable issues	37,712	77.94	181,319	70.73
B. Non-marketable issues				
U. S. saving bonds	4,314	8.91	45,586	17.78
Treasury notes—tax and savings series	....	....	10,136	3.95
Other issues	241	.50	505	.20
Total non-marketable issues	4,555	9.41	56,226	21.93
Total public issues	42,267	87.35	237,545	92.66
II. Special issues				
Old age and survivors' trust fund	2,381	4.92	5,308	2.07
Government retirement funds	656	1.36	1,868	.73
National life insurance fund	3	....	3,187	1.24
Unemployment trust fund	2,273	4.70	6,747	2.63
All other special issues	807	1.67	1,702	.67
Total special issues	6,120	12.65	18,812	7.34
Total interest-bearing debt	48,387	100.00	256,357	100.00

* Compiled from the *Treasury Bulletin*, August, 1941, and September, 1945.

The four-year period covered by Table LIV and by the one which follows (Table LV) corresponds closely enough with the term of our participation in the active fighting to illustrate the changes in the composition of the federal debt during the intense strain of war financing. The broad, overall view, provided by the total of the three major classes of debt (public marketable, public non-marketable, and special issues) reveals a substantial rise in the proportion of the total represented by the public non-marketable debt, consisting almost wholly of the savings bonds and the special tax and savings treasury notes. It has already been suggested that, notable as the sales record was, a far better record could have been

achieved in the sales of this class of debt instruments if the interest return had been better than it was.

The growth of the absolute amount of special issues was phenomenal, but it was determined by more or less objective factors, such as the taxable payrolls and the rates of social security taxes, the contributions to retirement and insurance funds, and so on. Larger amounts could have been borrowed from these trust funds if the respective rates of contribution had been raised. The entirely proper action of Congress in "freezing" the tax rates for old age and survivors' insurance year after year prevented the growth of this trust fund at a faster rate.

Most noteworthy of all was the shift in the composition of the marketable debt. While this class declined somewhat in relative importance as a major component of the total debt, the significant change was the marked decline of the share represented by treasury bonds, from 62.44 per cent of the total debt in 1941 to 41.52 per cent of the total in 1945. In terms of the marketable debt, the bonds constituted 80.2 per cent in 1941 and 58.8 per cent in 1945. The explanation lies, obviously, in the relatively greater growth of the short-term debt (bills and certificates) and intermediate debt (notes). Thus, the bills comprised 3.31 per cent of the total debt in 1941, and bills and certificates together accounted for 19.97 per cent in 1945.

A second noteworthy feature of the change in the composition of the debt over the period in question was the relative increase of the non-marketable public issues. The savings bonds doubled in relative importance, while the special tax notes and savings notes which were not used at all in 1941, advanced still further by 1945 the relative position of the non-marketable debt.

As a parallel to the growth of the debt and the changes in its composition during the second World War period, there should be noted the changes of ownership distribution in the same period. This is shown in Table LV, on page 588.

This table is limited to the public marketable issues. The special issues were virtually all held in the various government trust funds. The non-marketable public issues were held by the individuals or firms who originally purchased them.

The most striking shift of ownership is to be noted in the case of the treasury bills. The commercial banks held about two-thirds of the outstanding total on June 30, 1941. Four years later they held only about 16 per cent of the total. By contrast, the reserve bank holdings of bills had greatly increased. In fact, treasury bills comprised 59.5 per cent of all reserve bank investment in the federal debt on June 30, 1945.

The treasury certificate of indebtedness became an increasingly important form of short-term financing after 1942. It will be noted that the commercial banks and the "all other investors" group were carrying

much larger proportions of the outstanding certificates in 1945 than of the bills. This is likewise true with respect to the treasury notes.

TABLE LV
OWNERSHIP OF MARKETABLE U. S. GOVERNMENT SECURITIES AS OF END OF
FISCAL YEARS 1941 AND 1945 *
(MILLIONS OF DOLLARS)

<i>Class of Security</i>	<i>Com- mercial Banks</i>	<i>Savings Banks</i>	<i>Insurance Companies</i>	<i>U S Government Agencies and Trust Funds</i>		<i>All Other Investors</i>	<i>Totals</i>
				<i>F R B</i>	<i>Other</i>		
June 30, 1941							
Treasury bills	\$ 1,112	\$ 23	\$ 10	...	...	\$ 459	\$ 1,603
Treasury notes	2,931	191	259	820	45	1,452	5,698
Treasury bonds	10,864	2,895	5,983	1,359	2,046	7,263	30,411
Totals	14,907	3,109	6,252	2,179	2,091	9,174	37,712
June 30, 1945							
Treasury bills	2,798	...	4	12,962	3	1,273	17,041
Treasury cer- tificates of indebtedness	16,758	123	420	6,032	47	10,756	34,136
Treasury notes	16,037	281	601	1,685	52	4,841	23,497
Treasury bonds	41,476	9,364	19,892	1,113	5,968	28,636	106,448
Other bonds	16	1	1	...	35	143	196
Totals	77,085	9,769	20,917	21,792	6,105	45,649	181,318

* Compiled from the *Treasury Bulletin*, August, 1941, and September, 1945. The banks and insurance companies included in the treasury surveys account for approximately 95 per cent of the amount of all securities owned by banks and insurance companies in the United States. Holdings of guaranteed bonds excluded. Totals rounded.

In the two preceding tables the main story of the financing of the second World War is outlined. These tables show how much debt was created and who owned it on a date in 1945 midway between V-E and V-J day. The many decisions made with respect to the war financing contributed, in one way or another, to the record which is here summarized. In this record the problems of post-war debt management have their roots.

The principal characteristic of the foregoing record is to be found in the intense preoccupation of the Treasury with its cheap money policy. As already noted, this policy was made possible, first, by the gold imports and second, by the expansion of reserve bank credit. The cheap money produced by these inflationary procedures led to an emphasis upon short-term debt. A recognized principle of investment is that the yield tends to vary with the maturity of the obligation. That is, the shortest maturi-

ties afford the lowest return on the investment. The theory is that the low return is the price paid by the lender for liquidity. If he lends for short periods only, he can always terminate his loan quickly and have his funds available for any better investment opening that may appear.

The Treasury took full advantage of this presumed preference for liquidity. The political merit of the policy lay in the fact that the total interest cost of the debt was held down and the taxpayers were thereby appeased. Accordingly, it was explained that the debt was "tailored" to fit the needs of various classes of investors. But the figures given in Table LV show that the tailoring cut too close to the edge. The commercial banks bought the treasury bills but passed them along to the reserve banks which were obliged to buy them under the general Reserve Board policy of supporting the banks. The latter had repurchase options on about one-third of the total bills thus sold, which gave them all the advantages of liquidity and enabled them to avoid holding the very low-yield paper.²⁰ To a lesser extent the treasury certificates were likewise passed into the reserve banks.

Post-war debt management. In view of the huge debt that must be carried into the post-war period, the principal task of management will be that of refunding. In this connection a difficult but important decision must be made. It involves the future interest rate. Whatever the decision is, both political and economic factors of serious import are involved. Thus, there is a definite political advantage for the short run in a continuation of the cheap money policy, since it keeps down the budgeted interest cost and hence is favorable to further tax reduction. But the economic consequence of an artificially maintained cheap money policy is that it involves further inflation of bank credit, a condition which would present a continual threat to the price level unless price and wage controls were retained. Such retention, however, would become a distinct political liability, as would the price inflation that would follow their removal.

A decision to move away from an artificially maintained cheap money policy would no doubt require application by degrees. Among the first steps would be the gradual refunding of bills and certificates into long-term debt and the placement of these issues, so far as possible, with non-bank investors. This would be the reverse of the procedure whereby the cheap money policy would be effectuated, which is the refunding of maturing and callable bonds and notes into bills and certificates. The ultimate destination of this short-term debt would be the federal reserve banks, which would expand their outstanding bank credit to acquire the paper.

The budget requirements for interest would rise if the short-term debt

²⁰ As of June 30, 1945, the reserve banks held bills under repurchase options in the amount of \$4,874 million.

were to be funded into long-term debt. This would no doubt be considered a political disadvantage to the party responsible therefor, since it would compel heavier taxation, or at least would deter tax reductions. However, the termination of the credit inflation would be a definite economic gain, which would be reinforced by release of the economy from the controls that impending inflation would warrant. The principal economic danger would lie in a popular revolt against the debt burden and in some kind of compromise with respect to the principal.

Either course has its difficulties and its dangers. In the long run more is likely to be gained by adopting a frank, straightforward policy of refunding which would end the reliance on credit inflation. This, at any rate, would establish the problems of debt management in the realm of reality rather than illusion.

THE BASIS OF DEBT REDEMPTION

The creation of any credit obligation always gives rise to the question of what is to be returned to the lender when the debt is due to be paid. If the debtor fails to comply with the original terms of the contract through inability to pay interest or principal when due, the result is a "default." When he insists on modifying in some essential particular and to his own advantage, the terms of the contract, the result is "repudiation." Default is not repudiation, for it involves in no way the essential terms, but only the capacity of the debtor, which is a matter not always within his control. Repudiation is ordinarily not open to any debtor except sovereign governments, for any others who might attempt such a course would be liable to suits to compel observance of the contract terms. Sovereign states cannot be sued without their consent, and when any manner of debt repudiation is determined upon, steps are taken to withhold, or to withdraw, such consent.

The question first arose for the federal government after the Civil War, when an attempt was made to compel payment of bonds in paper money unless gold had been specified. Certain bond issues did not expressly indicate the medium of payment, hence it may be said that in the technical sense the demand of the Greenback party did not involve repudiation. The testimony as to what was intended and understood, in and out of Congress, pointed so strongly to redemption in gold or its equivalent that any other course would have been tantamount to repudiation.²¹

The matter became an active political issue in the campaign of 1868, and gold payment was assured, except where another medium had been expressly contracted, by an act of 1869. At the time the Greenbacks were worth less than par, being inconvertible, and the cheap money advocates saw a definite advantage to the Treasury in redemption of the war

²¹ Dewey, *op. cit.*, pp. 344, 349.

debt in an inconvertible paper currency. The restoration of the paper to parity with gold was established by the specie resumption act of 1875, effective January 1, 1879.

The next occasion for federal borrowing came in the midst of the cheap money agitation of the nineties, when bonds were issued to provide gold for Greenback redemption and to avoid Treasury suspension of specie payments. The interest rate on these bonds was to be 4 per cent, but it was stipulated that they should bear 3 per cent if Congress would agree to a gold clause. The proposal was indignantly rejected.

During the first World War all federal securities contained a gold clause, binding the government to pay interest and principal in gold coin "of the current weight and fineness." Although this provision had become, even then, a rather familiar practice in private borrowing, it was regarded as the more necessary as a support of the federal credit in view of the terms on which the war financing was undertaken. Although literally a promise to pay in gold, it was generally understood to be a contract to pay in any form of currency medium having the same value as the current gold coin. While the country remained on the gold standard, the value of all currency media was linked to that of gold, and payment was ordinarily tendered and accepted in bank credits.

This device may have been reassuring to investors, but it was obviously of little practical value. As long as the gold content of the dollar remained unchanged and other media of payment were on a par with it, settlement was accepted in any form of currency or credit, since the purchasing power thus obtained was equivalent to that of gold. Under a suspension of specie payments, with a resulting premium on gold, many debtors would have been obliged to default on their contracts through their inability to pay the gold premium. In other words, the gold clause was chiefly useful as long as it was not needed.

The real issue, under an inconvertible currency, is whether the debtor is obligated to pay an amount of the currency equivalent to the value of the gold referred to in the contract. This issue was precipitated by the devaluation of the dollar in 1933,²² when the gold content of the standard dollar was reduced to 59.6 per cent of its former amount. Concurrently with devaluation Congress abrogated the gold clause in all contracts, public and private.²³

In the test suits brought to determine the validity of this legislation, the issue presented to the Supreme Court was not that of literal fulfillment, since monetary gold had been nationalized, but that of paying an amount of the devalued currency equivalent to the present value of the former gold dollar.

²² This was done by proclamation of the President under authority of Title III of the *Agricultural Adjustment Act of 1935* (Public No. 10, 73rd Congress).

²³ *Joint Resolution No. 10, 73rd Congress* (H. J. R. No. 192).

Serious consequences were involved in these suits, whether the court ruled for or against the government. If the gold clause contracts were upheld, the total of all debt obligations containing it would have been increased by more than 60 per cent. The added burden on government and industry would have neutralized whatever benefits were assumed to flow from the devaluation. If abrogation were upheld, an act of bad faith with respect to contract obligations would receive judicial approval.

A majority opinion by five justices disposed of the issue in two parts. It was held that Congress could not abrogate the federal government's contract obligations expressed in the gold clause. The moral victory offered no material advantage, however; for it was pointed out that suits against the United States to recover could only be brought with consent of the federal government, and further, that any plaintiff must show that he had actually suffered damage as a result of devaluation. Congress later legislated to disbar suits of this character, thus completing practical abrogation.

On the other hand, it was held that Congress had the power to compel modification of the terms of other contracts, both public and private. This power the majority opinion discovered in the constitutional authority of Congress to regulate the currency and fix its legal tender power. The attempt of cities and business concerns to determine a certain basis of contractual payment was held to be an indefensible interference with the Congressional power to regulate the currency. The logic is fraudulent, like devaluation itself. Yet it served.

Since 1934 the country has operated on a *de facto* inconvertible currency basis, despite the vague and increasingly tenuous relationship to gold provided by the gold reserve requirements of the federal reserve banks and the privilege of obtaining gold for export, subject to Treasury approval. The period has witnessed the emergence of various soft money schemes, and it has experienced a phenomenal depreciation of the basic monetary unit through the credit inflation. As already noted, the full impact of this depreciation was warded off by the war-time price, wage, and ration controls. As things now stand, the public debt consists of the government's promises to pay dollars, but there can be no satisfactory assurance as to just what these dollars are. A quip that circulated during the Greenback controversy would not be inappropriate. It was: "This is a dollar. God help the United States of America."

SOCIAL SECURITY AND THE PUBLIC DEBT

The social security program that was established in 1935 has implications for the public debt that will vary according to the pattern of financing that is finally adopted. The original scheme contemplated the accumulation of a large reserve fund for old age benefits by 1980, which

would have been invested, of course, in federal securities. If this program had been carried out, and if no untoward circumstances had occurred to increase the debt, the old age reserve fund would have been, in 1980, the owner of virtually all of the federal debt. The transfer from the public to the fund would have occurred by the levy of payroll taxes greatly in excess of benefit requirements and the application of the surplus receipts, together with the interest on the fund, to the acquisition of outstanding debt. In part the surplus cash would have been used to retire outstanding, matured issues while the fund itself would have received from the Treasury special issues representing the receipts so applied.

The plan for a big reserve was abandoned in the 1939 amendments to the Social Security Act, and the Social Security Board was instructed to advise Congress from time to time as to the relation of the old age trust fund to the probable benefit requirements of the next three to five years. The idea was, apparently, to permit an adjustment of the payroll tax rates with a view to holding the reserve within moderate limits. Under these amendments the tax rate was held at 1 per cent of taxable wages for employer and employee, respectively, through 1942, and as to each of the four years following the rate was "frozen" at the same level. Nevertheless, the old age fund increased rapidly, partly because war-time employment induced many eligible beneficiaries to remain at work, thereby reducing benefit payments, and partly because the rise of wage payments broadened the base of the tax. The section of Table LIV entitled "special issues" indicates the size of the reserve in 1945.

The total of these special issues, representing the funds collected under the various programs operated by the federal government for retirement, insurance, and unemployment compensation, indicates the extent to which the Treasury benefited during its deficit operations before and during the war. The cash receipts of the several funds in excess of current payments, were borrowed and used for general government purposes. To this extent it was not necessary to go into the market for funds. Since the receipts of the social security and other programs were drawn from the current income of the prospective beneficiaries, no inflationary influence was involved in borrowing them.

It was pointed out in Chapter IV that the establishment of government trust funds necessarily involves the creation of a debt owed by government to the fund if the receipts are in excess of the disbursements. The alternative would be the accumulation of large idle balances in banks to the accounts of the respective funds. In the case of the federal government, the important question is whether or not there should ever be an attempt to operate its various fiduciary programs on any other than a current, cash basis. The idea of a fund is derived from the practice of private insurance, where a reserve of assets against liabilities is essential. But the nation need not follow this practice, since it has the power of

taxation, and also the power to compel all, or any classes, of citizens to join a particular program. It is therefore entirely feasible to put any retirement or other benefit program on a cash basis.

This would accord with the economics of the case. With respect to old age benefits, for example, those who are now gainfully employed would make contributions for the purpose of supporting the aged of this generation. Their support, in terms of real income, must be derived from the current product, and such levies on current payrolls as were required would merely be a diversion of current money income equivalent to the diversion of product. Those whose incomes had been levied upon would, in turn, be similarly entitled to support by the next generation of workers.

A special report on social security to the Ways and Means Committee in 1946 suggested that a regular, predetermined schedule of tax rates be adopted, with moderate increases at ten-year intervals. In support of this suggestion the report said: ²⁴

These suggestions are made with the thought that we should approach a pay-as-you-go method but should not be afraid of a trust fund; that it is a foregone conclusion that social-security taxes must increase in the future if they are to pay a substantial part of the benefit totals which we know are going to increase in a major way, that we want no irregularities or sudden breaks in our social-security tax schedule and that anything that may be undesirable about a modest further growth in the trust fund during favorable economic conditions is far less important than the painful processes of meeting unusually high benefit loads in years of economic depression after we have been somewhat lulled into complacency by an unusually low benefit load and unusually high contribution totals, due to unheard-of employment conditions.

At the tax rate schedules proposed, which were 1½ per cent on taxable wages to be paid by employee and employer, respectively, through 1956, with ½ per cent increase on each side for each ensuing decade to 1977, it was estimated that the reserve fund might be as high as \$30.5 billion, or as low as \$19.5 billion, by 1971, under these rates.

Under any scheme of rates, there would be two ways of covering any deficiency caused by an excess of benefits over current receipts plus interest on the fund. One would be a contribution from general revenues, the other would be a realization of a portion of the fund assets by redeeming special issues held in the fund from the proceeds of debt sold in the market. This would not be an overall increase of the public debt. Opinion generally, including that expressed by the staff of experts cited above, inclines toward the federal contribution. It must be pointed out, however, that this could involve heavier taxes at a time when a general tax increase would be as painful as the adjustments of the social security tax rates

²⁴ *Issues in Social Security. A Report to the Committee on Ways and Means of the House of Representatives* by the Committee's Social Security Technical Staff. Washington, 1946, pp. 121, 122.

would be. If we are not to be afraid of a trust fund, we should not be afraid to draw upon its principal, if and when equalization between current receipts and current outgo becomes necessary.

INTER-GOVERNMENTAL DEBTS

Upwards of two-fifths of the federal debt at the close of the first World War represented advances to the Allied governments with which the United States was associated. They had purchased huge quantities of war materials and supplies in this country, for which the producers were actually paid by the United States, through the medium of credits extended to the foreign purchasing agents. It was assumed at the time that these credits were loans, and in each instance the allied country delivered to the United States an acknowledgment of debt before the credit was extended. The debtor country stood committed to the repayment of this debt at some future time. The debt acknowledgment and the engagement to repay were in no way conditioned, then, upon collection by the debtor country of indemnity or reparations from Germany, although later developments implied an assumed connection.

During the second World War material assistance to the powers associated together against the Axis became necessary. It was supplied mainly under the Lend-Lease Act of March 11, 1941. The question of obligation arising out of these transactions was disposed of in a paragraph of the act which provided that the benefit to the United States may be payment, or repayment, or any other direct or indirect benefit which the President deems satisfactory. There was some reverse lend-lease, that is, provision of supplies by other countries for the use of the United States. The record to October 1, 1945, was as follows:

TABLE LVI
SUMMARY RECORD OF LEND-LEASE AND REVERSE LEND-LEASE *
(MILLIONS OF DOLLARS)

<i>Country</i>	<i>Lend-Lease Exports to October 1, 1945</i>	<i>Reverse Lend-Lease Aid Received, to July 1, 1945</i>
United Kingdom	\$13,842	\$4,241
U. S. S. R.	9,478	2
Africa and Middle East	3,393	†
China and India	2,353	643
Australia and New Zealand	1,459	1,040
Latin America	247	†
Other countries	1,744	333
Totals	\$32,515	\$6,257

* Source *Twenty-first Report to Congress on Lend-Lease Operations for the Period Ended September 30, 1945*, pp 18, 19.

† Included with other countries

The transactions whereby American resources were made available to Allied nations differed materially in the two wars, although the objective of providing munitions, food, clothing, and other things was the same. In 1917 and 1918 dollars were loaned to Allied governments and spent here by the agents of these governments. The transaction was a loan of money to be repaid.

In the second World War the government was authorized to "sell, transfer title to, exchange, lend, lease, or otherwise dispose of, any defense article. . . ." The goods so supplied were produced here, paid for by the government, and sent to the allied nations, whose representatives indicated the kinds and quantities of things needed. Despite the use of the terms *lend* and *lease*, which naturally suggest a return in some form, it is clear that the discretion vested in the President to recognize as adequate any kind of benefit enjoyed by this country precludes any question of money settlement, or even of repayment in kind.

After all, this is the only sensible solution, regardless of the original terms under which the advances were made. In war, mutual aid is essential to the safety of all. The collapse of German reparations and of inter-Allied debt payments after the first World War should be a reminder of the outcome in any parallel case, if this country should ever be so ungracious as to raise the issue of repayment.

War always produces economic exhaustion. None of the European countries involved in the second World War had fully liquidated the losses and costs of the first World War when the second began. Many of them were still carrying enormous debts; their currencies were weak; their domestic living standards were depressed; and they had been unable to attain any sort of stable economic relations with the rest of the world. The second World War completed the process of economic depletion and exhaustion that the first had started. With the exception of Russia, the whole of Europe was economically prostrate. The long and devastating war in the Orient had produced similar conditions there. A part of the Teutonic ideology had been the proposition that war is a rejuvenating and vitalizing experience. Some American commentators were foolish enough, in the early years of the recent conflict, to echo such nonsense. In the face of the world-wide famine, the mountains of debt, and the devastated lands, only a complete fool could say that war produces anything but utter ruin. The technical advances achieved by compressing a generation of scientific research into a few months or years are a pitifully small recompense.

It was apparent that the United States had a responsibility to promote and assist rehabilitation and reconstruction. The procedures selected, by which this responsibility is to be met, were hardly the wisest that could have been found. They consisted of a huge fund for the stabilization of foreign exchange rates, a world bank, and a series of loans to be made

by the United States. The largest single subscriptions to the fund and the bank were also to be made by this country.

The matters of theory and policy involved in the operations of the fund and the bank are too complicated to be dealt with here. Few have realized that, despite their ostensibly beneficial purposes, these institutions constitute impressive milestones marking the distance that even the United States has traveled along the road toward the totalitarian economy. Thus far, in the long history of international trade transactions, their financing has been a responsibility of private capital. Government's part has extended no farther here than in the financing of domestic trade, namely, to provide a dependable monetary unit and to maintain the conditions of peace and security necessary for orderly trade. Only during the two great wars has government intervened to engage as a principal in direct dealings.

The old system did not always work perfectly, but it worked. Its breakdown became most evident when the politicians of various countries began to introduce currency devaluation, quotas of exports or imports, exchange blocking, and all the other controls and devices that were developed to force their domestic production and their external trade into the channels which, it was assumed, would best serve the political conception of the national interest.

Now, after the second World War, national governments have entered the field of international finance. It is inevitable that they should henceforth dominate it, whether or not the essential qualifications for leadership are manifest. It is equally inevitable that the domination will be primarily political, and that bona fide economic factors and considerations will be subordinated when they are not wholly neglected. And finally, it may be accepted as axiomatic that governmental intervention in and domination of external trade will lead to greater controls over domestic production and trade. Hence the institutions that were devised at Bretton Woods may fairly be regarded as markers of the advance toward the regimented state.

Support for the huge contributions to the new financial institutions and for the post-war loans to various countries has been based principally on the ground that domestic prosperity would thereby be promoted. The acceptance of this line of argument was simply astounding in view of the fact that has been so repeatedly demonstrated, namely, that neither an individual nor a nation can prosper by giving away goods or services on which costs of production have been expended. Lending the customer the money with which to buy is a valid procedure only if the loans are to be repaid. There is nothing in the history of the kind of lending that has been so vigorously advocated to establish that they will be repaid. It is international rather than domestic pump-priming. So far as employment and production here are concerned, there is little to choose between the

two. The burden of the loans and the subscriptions will fall upon the American taxpayer.

The position taken here is restated in the interest of assured clarity. England, France, and other countries need material help in recovering from the devastation of war. This country is the principal source of that help. It would be a generous action to provide aid. The fraudulent part of the affair is the bold-faced attempt to conceal the gift under the guise of a business transaction. These deals cannot be classed as business transactions unless the money loaned is to be repaid. It is utterly beyond probability that the governments of England or France will maintain principal and interest payments on loans from this government over a period of more than 50 years.

Moreover, should this be done, with or without pressure from the creditor, it would not make for good relations. A whole generation of persons not yet born must accept higher taxes and some restriction of consumption if these commitments are to be fulfilled. Only a most gullible person would now believe that these as yet unborn taxpayers and workers will bear such privations on our behalf cheerfully and gratefully.

It is granted that rehabilitation aid is needed, but in this writer's opinion, a loan by one government to another is the worst of all ways to provide it. While the other options were not in all respects entirely acceptable, they deserved more careful consideration than was given to them.

One option was private loans. The difficulty here is the bad record of such loans, but a government transaction cannot assure a better record in future. A second option would be a gift made under the guise of lend-lease. But this idea was galling to the foreign politicians and unacceptable to the politicians of this country. On both sides it seemed better politics to sugar-coat the gift by calling it a loan. A third method would be a cash transaction on a quid pro quo basis. The most obvious foreign asset for such a deal, and the one that would be most acceptable here, consists of various parcels of real estate in the Atlantic and elsewhere. The long-range defense plans of this country will no doubt have a place for strategically situated naval and air bases outside the continental limits. Even if the price at which they were transferred were on the high side, this fact would serve later as a rejoinder to any complaint that undue advantage had been taken of present necessity.

If any of these options had been selected, the essential purposes of aid to reconstruction would have been served. The transaction would have been made, written off, and forgotten. There would have been no deception of the American people as to what was done, what it would cost, and who would pay for it. Best of all, there would have been one less opportunity for the "tub-thumpers" on both sides of the Atlantic to foment suspicion and discord.

CHAPTER XXXIII

State and Local Debt Policies and Problems

THERE WAS A time when the principal and annual interest cost of state and local debt bulked large in the nation's fiscal situation. In 1930, for example, the total of these debts exceeded the federal debt. Since then the various circumstances of depression and war have carried the latter to levels which cause the debt position of the states and their subdivisions to appear, by comparison, idyllic. Nevertheless, there are matters of burden and policy which require consideration.¹

THE GROWTH OF STATE AND LOCAL DEBTS

Detailed statistics of the early development of state and local debt are not available. Professor H. C. Adams stated that the total debt of the American cities in 1840 was little more than \$25,000,000, and that the debt of all cities of 7,500 population and over in 1860 was about \$51,000,000. He estimated the total of all local debt obligations as of this date to be hardly more than \$100,000,000.² The states had plunged heavily in the use of public credit between 1830 and 1850, and some of them had resorted to repudiation to escape the consequences of their folly. Previous to the Civil War, however, the cities had remained comparatively free of debt, as these estimates indicate, a course to which they may have been led, possibly, through contemplation of the disastrous results of state borrowing. According to Adams, there is no evidence from this period to indicate either the abuse or the mismanagement of municipal credit.

The decades following the Civil War saw the beginning of a larger use of public credit by local subdivisions, and the appearance of serious abuses. By 1870 the total local debt had mounted to \$515,800,000, and a decade later it reached \$821,486,000. The financing of the Civil War by means of loans had done much to initiate the whole country into the possibilities of credit as a resource to be developed in lieu of taxes, while the inflation induced by the excessive federal loans made the tax burden

¹ For a comprehensive survey of these problems, cf. B. U. Ratchford, *American State Debts*, Durham, North Carolina, 1941.

² H. C. Adams, *Public Debts*, p. 343.

heavier, and so afforded an apparently valid excuse for the resort to credit. Furthermore, the country's education concerning the nature of credit had been intrusted to Jay Cooke and others whose first aim, during the war, was to sell bonds, and many persons were converted to the doctrine that a public debt is a public blessing. This doctrine seldom has difficulty in gaining both converts and advocates.

The cities and other local units did not long maintain their record of proper use and able management of their credit. During the period of business activity and speculative enthusiasm which preceded, and finally culminated in, the crisis of 1873, all sorts of excesses were committed, the character of some of which is revealed by the purposes for which bonds were issued. Thus, in 1880 the gross debt-incurred by cities and other local subdivisions to aid railroad construction was \$185,238,000; another \$153,949,000 had been issued to fund floating debts; and some \$138,743,000 were refunding bonds. The aggregate of these three items, in round numbers \$478,000,000, represented 42.8 per cent of the total gross debt of localities as reported in 1880.³ None of these objects represents a proper use of local public credit. Many state constitutions had been amended to forbid the use of state credit in aid of internal improvements, but the early amendments were not specifically applicable to the local units, and the cities were thus allowed to undertake a misuse of their credit that had been forbidden to the states. The large floating debts indicate an unwillingness to levy sufficient taxes for current purposes, and the vicious practice of refunding reflects likewise the failure to meet debt obligations when due.

TABLE LVII

TOTAL AND PER CAPITA STATE AND LOCAL NET DEBT, 1890 TO 1942 *
(TOTALS IN THOUSANDS)

Year	State Debts		Local Debts	
	Total	Per Capita	Total	Per Capita
1890	\$ 211,210	\$ 3.37	\$ 925,990	\$ 14.79
1902	234,965	2.99	1,630,070	20.34
1912	345,942	3.57	3,475,954	35.81
1922	935,544	8.64	7,754,196	71.32
1932	2,373,634	19.06	15,215,881	122.21
1942	2,620,320	19.90	13,493,560	102.48

* Source. United States Census Bureau, *Wealth, Public Debt and Taxation, 1922*; *Financial Statistics of State and Local Governments, 1922*, and *Governmental Finances in the United States, 1942*.

Local borrowing was restricted by further constitutional changes during the seventies, and the rate of local debt increase slackened materially in the next decade, for all minor subdivisions reported a total of

³ *Tenth Census of the United States, 1880, Vol. VII, p. 674.*

\$925,990,000 in 1890. The growth of state and local net debt, that is, the gross debt outstanding less assets held in sinking funds for redemption purposes, is best presented in tabular form. This is shown in Table LVII.

This is at once an impressive and a disturbing record, for during much of the period covered the relative increase has been at geometric ratios. Both the state and the aggregate local debt more than doubled from 1912 to 1922. The state debt almost trebled again from 1922 to 1932, while the local debt almost doubled again in the same time. The per capita figures naturally do not rise quite as rapidly, yet their increase has been such as to reveal a heavy advance in the relation between outstanding net debt and the number of persons to be served by the expenditure of debt proceeds.

Concentration of the debt increase. The aggregate of state and local debts in Table LVII suggests that loose borrowing practices were general, but closer examination of even such limited data as are supplied by the Census Bureau reveals a remarkable and growing concentration of the bulk of the state debt in certain states. In 1890, four states, Alabama, Missouri, Tennessee and Virginia, were carrying 37.3 per cent of the total state debt, and a group of fourteen states had 60.7 per cent in all. In 1912, three states, Massachusetts, New York and Virginia, were responsible for 53.6 per cent, and twelve states accounted for 72.7 per cent. A similar concentration obtained in 1922, when five states (California, Massachusetts, Michigan, New York and Pennsylvania) carried 48 per cent, and seventeen states had 75.8 per cent; and also in 1932, when six states (Arkansas, California, Illinois, Missouri, New York and North Carolina) had issued 53.7 per cent, and eighteen states⁴ had issued 84 per cent of the total. Some readjustment of debts occurred during the decade 1932-1942 which amounted to a still greater diffusion. In the latter year the seven states having net state debts in excess of \$100 million had a total of \$1,120,2 million or 42.7 per cent of the outstanding total. In other words, there has been a group of states, slowly increasing in number, that has been responsible for a large proportion of all state borrowing. All of the other states have borrowed more or less, but in no case have the amounts outstanding been large in the years reported upon by the Census Bureau.

Distribution of the local debt by borrowing agencies. The net outstanding debt of the several classes of subdivisions for each year covered in the census reports is given in Table LVIII.

The limitations of the Census Bureau's classification according to local units prior to 1932 obscures the distribution of local debt except as to counties. While the municipalities have always been the principal local

⁴ Alabama, Arkansas, California, Illinois, Massachusetts, Michigan, Minnesota, Missouri, New York, New Jersey, North Carolina, Oregon, Pennsylvania, South Carolina, South Dakota, Tennessee, Virginia and West Virginia.

borrowers, the census figures understate the total borrowing for school purposes, since the school debt is in some cases an obligation of the municipality, and in other cases of the county, rather than of a separate school district.

TABLE LVIII
DISTRIBUTION OF LOCAL NET DEBT BY BORROWING AGENCIES
(MILLIONS OF DOLLARS)

Class of Subdivision	Amount of Net Long-Term Debt Outstanding in					
	1890	1902	1912	1922	1932	1942*
Counties	\$145.0	\$ 196.6	\$ 371.5	\$1,272.8	\$ 2,390.8	\$ 1,742.6
Cities, towns boroughs and villages	699.1	1,346.8	2,884.9	4,703.3	8,842.2	7,798.6
School districts	....	..	...	..	2,039.8	1,721.1
Townships	81.8	86.7	219.5	1,778.1	343.9	225.7
Other civil divisions	....	..	....	..	1,599.1	2,055.0
Totals	\$925.9	\$1,630.1	\$3,475.9	\$7,754.2	\$15,215.8	\$13,543.0

* Figures do not add to total shown in Table LVII

As in the case of the states, there is a certain sectional concentration of the local debts, which is determined by the relative importance of the several classes of local units as administrative agencies. County debt is unimportant in the New England, Mountain and Pacific sections, and the per capita county debt is highest in the middle Atlantic group. The separately reported school debt is naturally concentrated in the sections in which this agency of local school administration is emphasized.

The purposes of state and local borrowing. Some light is thrown on recent developments of state and local borrowing by the purposes for which the funds have been used. Data for the states and the larger cities have been presented by the Census Bureau, and Table LIX is compiled from this source. More recent data are not available.

This distribution of purposes is not entirely satisfactory, because of the vagueness of state and local borrowing practices. For example, it was impossible to classify and report \$363,100,000 of state debt in 1931, or over 16 per cent of the total then outstanding. Hence it was entered as having been issued for combined and unreported, or miscellaneous purposes. The total amount of city debt outstanding in 1931 for unsegregated or unidentifiable purposes was \$878,368,000, or 14.77 per cent of the total. This vagueness is due in part to the local practice of combining two or more purposes in a single issue without taking care to indicate the segregation. It is also a natural concomitant of the extravagant use of

public credit that occurred during the past generation, and the fact that one-sixth of the state debt, and one-seventh of the debt of the larger cities could not be definitely classified according to the purposes of issue testifies to the slackness, haste, and comparative indifference of governing bodies toward state and local debt management.

TABLE LIX

RELATIVE DISTRIBUTION BY PURPOSES OF GROSS DEBT OF STATES AND OF CITIES OF 30,000 POPULATION AND OVER, 1915 AND 1931

Purpose	Percentage of Total Debt			
	States		Cities	
	1915	1931	1915	1931
General government	3.67	1.90	4.64	3.18
Protection *	1.19	.18	2.15	1.67
Conservation †	.04	.18	...	..
Health and sanitation	.	.	10.60	13.56
Highways	48.17	63.66	23.14	24.20
Charities, hospitals and corrections	3.94	3.70	2.62	3.06
Education	1.80	2.52	19.24	29.51
Parks and playgrounds	1.57	1.27	8.24	5.90
Soldiers' and Sailors' aid and homes	.10	10.07	...	...
War loans	.29	.30	...	...
Miscellaneous	22.91	6.15	4.31	3.00
Combined or unreported	16.32	10.07	19.69	11.77
Special assessments	...	...	5.37	4.15
Total general purposes	100.0	100.0	100.0	100.0

* State debt for armories, city debt for police and fire departments

† State debt for agricultural purposes

Insofar as the purposes of issue are revealed, the figures suggest that the influences back of the rapid rise of state and local debts have been much the same as those that produced the increase of state and municipal expenditures. That is, the principal purposes for which loans have been issued are education, highways, sanitation and welfare. These are the governmental services that have been so largely responsible for the over-all increase of state and local expenditures. A more important question is not answered by these or any other statistical compilations. It is the question why loans were so extensively used rather than heavier taxes to finance the expansion.

The preference for loans rather than taxes. One reason for the large amount of borrowing has been the belief that this was a less burdensome method of financing than taxation. The element of truth in this proposition has usually been lost sight of, or has been distorted to imply that in

some mysterious way the use of credit has meant a net addition first and last to the community's purchasing power.

The experience of New York City supplies some interesting material in this connection. During the years 1926 to 1933 inclusive, the bonds issued for all purposes totaled \$1,143,616,000. In the same period the total provision for debt service was \$1,072,568,000. In other words, had there been no city debt in 1926, the city could have provided from current sources, for all sorts of improvements, virtually as much as was in fact borrowed for these improvements, without increasing the tax rates.⁵ But there would have been this tremendous difference in 1933, namely, that the improvements would then have been paid for, whereas the loan method meant that in addition to raising more than a billion dollars during the eight-year period for debt service, the city must yet repay the huge additional debt incurred, together with several hundred millions in interest on the same before it is extinguished.

To this it will be said, of course, that the city could not have enjoyed the marvelous expansion that has come to pass without liberal use of its credit to finance public improvements that were required by its growing population. Here is presented a second general reason for borrowing, namely the urge to expand.

This motive has expressed itself in the furious haste in which the supposedly advantageous improvements must be constructed. Many communities have been caught in a vicious circle of expansion and expensive construction. They have borrowed to construct, hastily, public improvements to attract population, and the influx seemingly compels further quick construction, to be paid for by loans; still greater numbers come, possibly attracted by the improvements, further expensive construction is required, and so on. It is difficult to determine in how far the population pressure has been cause or effect. The more leisurely tempo of construction and improvement enforced upon any community by adhering more closely to a pay-as-you-go policy for improvements would at least eliminate the artificial stimulus provided by the loan method.

To be sure, this method would, in the beginning at any rate, be highly displeasing to those whose primary interest lay in the speculative increase of land values. Long ago Adams pointed out the interrelationship between the typical local tax system, the preference for borrowing, and the speculative hope that land value increases would offset the ultimately greater cost of this method of financing improvements. Local taxes fell mainly on the property owners, who naturally inclined toward such temporary relief as borrowing might have afforded. He charged, further, that there was a general disposition to spend a considerable part of the proceeds of loans in the construction of showy public buildings, public

⁵ Dun and Bradstreet, Inc., *The Finances of New York City*, Report No. 350 (June, 1934).

works and other evidences of a thriving community with the deliberate expectation of attracting population to these centers of prosperity. If and when the scheme worked, the first effect was an enhancement of real estate values, with large profits for the owners, and for the promoters of land development. The immediate speculative profits were the greater since the cost of the improvements had been spread over a series of years.⁶

The growth of cities has always been accompanied by varying degrees of land boom fever. Sometimes this has flared up into an epidemic that has induced an orgy of borrowing and spending before a "chill" succeeded the fever. The history of Florida cities provides excellent illustrations of this feverish speculative expansion, but the record of few large cities is entirely free from similar, though not always such violent, manifestations. The restriction of immigration and the declining net annual increase of population point toward greater stability of numbers and of their geographical distribution. In time more cities may be able to view the question of improvements in reasonable perspective, and thus to arrive at a saner basis for the use of public credit.

The curious notion that credit is somehow a burdenless way of financing has induced great carelessness in its use. New York City again provides superlative illustrative material. Prior to 1914 it was a common practice to issue forty- and fifty-year bonds to buy brooms, water pails, window shades, and even for digging holes in the sand at Coney Island and filling them up again.⁷ As late as 1929, the salaries paid by the board of water supply were being financed by fifty-year bonds.⁸

The fallacy of the belief that it is always necessary to borrow to provide the allegedly urgent improvements is shown by the results in some states that refused to be stampeded into excessive borrowing for road purposes. In Table LIX, the highway debt was 63.66 per cent of all state debt in 1931. In this year there were eighteen states that had no highway debt, and \$1,181,560,000, or 94 per cent of all debt for state highways, had been issued by sixteen states. While these states now have good state highways, they are not alone in this respect, and they have the additional bitter prospect of having to carry more than a billion dollars of highway debt as the price of getting their roads in such large measure by loans rather than by taxation. Urgency is always relative. Easy money offers a powerful temptation to foreshorten the perspective and to view as urgently necessary many things that would be deemed relatively unnecessary, or at least dispensable, if taxes were to provide the funds.

The availability of funds. The enormous volume of state and local borrowing that occurred between 1912 and 1932 could not have happened

⁶ H. C. Adams, *op. cit.*, pp. 353 ff.

⁷ Dun and Bradstreet, *op. cit.*, p. 54.

⁸ Typewritten statement furnished by the controller's office.

except with the aid and consent of investors. Funds were plentiful and the tradition that had been built up with respect to the inviolability of public credit assured a ready market for everything that was offered under the rubric of state or local bonds. Neither the investors nor the public officials paid much attention to such matters as the available community resources, the actual need for the improvement and the degree to which it would lead to greater ability to support the loan, or the other long-run prospects of meeting the debt service.

Public commercial enterprises. The expansion of local investment in commercial undertakings, and the general tendency to borrow the funds for these purposes, has also contributed to the increase of local debt. There has been wide diversity in this respect. The cities of the North Atlantic and North Central sections have consistently had a larger proportion of their total debt in this form than the cities of other geographical sections. The proportion is also greater in the case of large cities, wherever located.⁹ In 1880 the debt classified as "productive" by the Census Bureau comprised for all cities 24.5 per cent of the total debt. This proportion had risen to 31.6 per cent in 1912, and in 1931 it stood at 33 per cent. The bureau regularly adds the stereotyped comment, with reference both to the state and the municipal debts of this class, that

... the revenues derived from public service enterprises are usually sufficient to meet the interest and sinking fund requirements on account of their indebtedness, in addition to the cost of their maintenance and operation...

While this may be true, taking the field of municipal public service enterprise as a whole, it is not true of all instances of such activity. If the debt charges are not fully met out of the income from the undertaking, it means either a steady increase of debt or heavier taxes. In some instances this outcome may be justified by a broad interpretation of municipal social welfare functions, while in others it is simply the result of bad judgment in launching the scheme at all, or bad management in its operation.

Tax limitation. The policy of limiting or restricting tax rates or tax levies has also influenced the increase of local public debt. The forces making for increased expenditures have been too powerful to be completely held in check by this means, and despite debt limitations, the borrowing has gone on. A number of states now have tax limitations expressed in one way or another, but Ohio's experience has been sufficiently long to indicate the force of the expenditure pressure. In 1910 the total local debt in that state was \$188,146,000, representing a per capita burden of \$39.25. The first tax rate limit law was enacted in 1911, and by 1922 the local debt had risen to \$679,087,000, equivalent to a per capita

⁹E. C. Clark, "Purposes of the Indebtedness of American Cities," *Bureau of Municipal Research, Bulletin No. 75* (1916), p. 18.

debt of \$113.84. The peak was reached in 1930, when the local debt totalled \$976,000,000 in round figures, and the per capita was \$146.85. There was a decline to \$898,600,000 in 1932, but the relief requirements of the depression introduced an abnormal element in the situation that compelled further borrowing.

The auditor of state reported in 1917 that there were eighty cities in the state in which the aggregate tax levies were insufficient to pay the debt service. He added that they were, perforce, operating entirely on borrowed funds. He stressed the increasing seriousness of the situation in subsequent reports, and the growth of the local debt to 1930 reveals the basis of his comments.¹⁰

The Ohio local debt situation has greatly improved since 1930 as a result of sweeping measures taken to correct the evils produced by the earlier short-sighted reliance upon tax limitation. New taxes and a broader basis of state revenue sharing were introduced. Aggregate expenditures have been controlled and the total local debt in 1944 had declined to \$511,260,000.¹¹

Improper functional allocation. To some extent the increase of local debt has been caused by the obligation of local units to carry administrative responsibilities and governmental functions that require expenditures in excess of their current revenue resources. Many states have given consideration to the question of the proper distribution of state and local revenues, but none of them have fully weighed the question of a distribution of state and local functions in relation to the revenue resources assigned to each. The revenue sources have been the cause of much solicitous tinkering, but the relative functions of state and local governments have been left very largely to historical evolution, modified by accidental developments, as has been emphasized already. Permanent financial relief can be achieved only by a careful and thorough readjustment of both resources and administrative responsibilities between the state and its local units.

NATIONAL AND LOCAL DEBTS CONTRASTED

In the use of public credit by central and by local governments, respectively, some important differences emerge with respect to the legal and economic characteristics of the operation.

Differences in legal status. The national government is endowed with sovereign powers, and the validity of its debt obligation as a contract rests on the sovereign's good will and beneficent intentions toward the creditors. Should such a government decide to repudiate its debt there is

¹⁰ *Annual Report of the Auditor of State*, 1917, p. 10; *ibid*, 1925, p. 17; 1926, pp. 18, 19; 1932, p. 23.

¹¹ *Annual Report of the Auditor of State*, 1944.

no protection and no recourse for the creditors. On the other hand, the minor subdivisions of government are not free to escape their debt obligations by repudiation. This is true, certainly, with respect to the general lien obligations of local subdivisions. The legislature has the power to enact tax legislation applicable to them, and the courts will, if necessary, issue writs of mandamus to compel the proper officials to levy and collect the taxes. The common law rule in New England is that the estate of any inhabitant of a city or town is liable to be taken on execution of a judgment against the corporation. If a city or other local subdivision should deliberately set about to evade its debt, a sufficient number of ways of causing delay could doubtless be found to induce most creditors to suggest compromise, if not to abandon their claims altogether. Such a policy would probably be futile in the end, although Adams refers to the surrender of its charter by the City of Memphis as an instance of successful municipal evasion. Wholesale migration has occurred from some Florida communities that were hopelessly burdened with debt during the boom years.

The case is sometimes different for local bonds that are not a general municipal obligation. In this class would fall the special assessment or special improvement bonds, issued to finance paving or other improvements. Such bonds may be secured by a lien on the specific property improved, and the city, in such cases, is not directly responsible for payment. A situation arose in the state of Washington whereby the lien of improvement bonds was wiped out by the formality of a sale of the property to collect delinquent property taxes. A decision of the United States Supreme Court in a Texas case imperiled the validity of a large quantity of road district bonds in that state, but the legislature recognized and accepted the moral obligation involved by enacting validating legislation.

The imposition of severe tax limitations cannot be regarded as a move in the direction of local repudiation, for such restrictions would never be accepted by the courts as binding with regard to the debt incurred prior to the date of enactment, and a fundamental condition to the legality of that subsequently issued would be that the necessary levies for interest and sinking fund were included within the tax limits imposed. The resort to such legislation weakens the basis of local credit, however, by throwing greater uncertainty about the matter of adequate levies, and opening at least the possibility of vexatious delays while errors are being corrected. Contributory to this uncertainty is the further fact that local officials do not always observe the law strictly nor construe it properly. The investor who buys bonds issued in a state that has drastic legislation of this sort knows that he may be buying trouble, and will be correspondingly difficult to interest in the securities issued under such conditions. It is impossible to maintain credit on a high level while indulging in any sort

of antics that cast doubt upon the debtor's willingness or ability to meet his obligations.

The situation of the American states with respect to their debt obligations is one which Adams regarded as anomalous from the standpoint of the theory of public law. The anomaly arises from the fact that the states, which have delegated to the federal government such attributes of sovereignty as the determination of war and peace, as well as various others, acquire the immunity of the sovereign as soon as they incur a debt, at least with respect to that debt. In other words, any of the states may repudiate its debt, and be immune from suits to compel payment, except insofar as other states may have acquired such bonds as bona fide investments. This immunity was secured by the Eleventh Amendment, which was adopted as the result of a suit brought against the state of Georgia in 1792.¹² The states were so horrified at the thought of being made defendants in the federal courts that the amendment was speedily enacted. As a matter of fact, the chief service rendered by the amendment has been to enable a number of the states to refuse payment of their debts.

The purpose of national and local borrowing. The contrast between national and local purposes in the use of public credit is not always valid, but in general it may be said that national debts are incurred under the pressure of great emergencies, while local debts are incurred mainly to promote local development. Exceptions may be cited on both sides. The federal government borrowed part of the cost of the Panama Canal, a great developmental enterprise. Emergencies do occur in local finance and are met by borrowing. The sudden need for paved roads was evidently considered to be an emergency in some states but not in others, if the methods of financing constitute an indication of the viewpoint.

Prior to the depression of the thirties, war had been the principal reason for federal emergency borrowing. Ordinarily, war costs have been borne entirely by the federal government and have had little direct effect on local indebtedness, although Table LIX shows a small proportion of state debt classified as war loans. The depression compelled both national and local governments to borrow in violation of the ordinary canons of good loan policy. The shrinkage of revenues and the obligation to provide relief for large numbers of unemployed made borrowing the only available source of expendable funds in view of the restricted tax methods of the time. Loan receipts were used very generally for current operating expenses, a fact that should have persuaded both national and local governments to exercise restraint upon the volume of borrowing. But the country was in the grip of the experts in panaceas during these years, and of these spurious remedies, none was more persistent than the idea that by working less, producing less, accumulating less, yet borrowing more, the country could become more prosperous.

¹² *Chisholm vs. Georgia* (2 Dallas 419).

Differences in debt management. Again the contrast is by no means complete, for the general principles underlying the use of public credit are applicable to all grades of governmental authority. The federal government is not immune from, nor superior to, the rules that should govern local borrowing. Some defensible variations in debt management arise out of the differences in the scope and character of central and local governmental authority.

Thus, debt limitation is entirely proper for local governments, but it would be futile in the case of national governments. The nature and extent of emergencies are not reducible to precise limitation, and in theory, the state cannot be bound by any restriction that would hamper its freedom to act or to borrow. Sovereignty means freedom from hampering restrictions of this sort. Some state constitutions limit the amount of state debt, but the states, although deemed to be sovereign, are cushioned against the impact of the worst emergency situations by the federal government.

The amount of federal debt that may be issued is always determined by law, and in this sense there is a federal debt limit. But laws can be repealed or amended at will. They are quite different from a constitutional limitation. Moreover, the federal statutory limit is always high enough to permit additional borrowing in any given fiscal year.

Further, different rules may be justifiable with respect to refunding and repayment. Aside from the self-sustaining debt issued on account of public enterprises, the refunding of local debt is to be regarded as bad practice. This is particularly true insofar as the debt was incurred to finance public improvements, for the roads, buildings and other public works deteriorate with time and use and must eventually be replaced. Unless the debt for original construction is redeemed within the useful life of the improvement, it means pyramiding of new on old debt, for the same purpose, an abuse of public credit which, if prolonged, is fatal.

While it is always advantageous that the national debt be redeemed as soon as possible, its refunding is less serious in that there is no approaching obligation to replace wasting tangible assets by borrowing again. Such loss or wastage as may have occurred in the case of federal borrowing happened once for all as the immediate war or depression expenses were paid. Aside from the question of aggregate cost, the main argument against undue delay in redeeming the federal debt is the possibility that another serious emergency may appear before the debt created to finance the last one has been redeemed. National debt pyramiding from one great emergency to the next is as serious as it is for any local government to borrow for replacement while the original construction bonds are still unpaid. The European debt burden is the fruit of national debt pyramiding under the fallacious notion that a perpetual debt is cheaper.

There is also some question as to the most appropriate methods of

redemption for central and local debts. Adams was disposed to favor the use of sinking funds by local governments although he deprecated this method of extinguishing national debts.¹³ Subsequent experience compels a reversal of this judgment with respect to local sinking funds, and, as indicated in an earlier chapter, redemption by serial maturities has been very generally substituted. On the other hand, it would be unwise to impose on the federal government the obligation to issue all bonds in serial form, for the reason that at the time of borrowing it is impossible to forecast when repayment can be undertaken.

Local sinking funds. The general transition from term maturities and sinking funds to serial maturities in local finance was inspired by the difficulties encountered in sinking fund management. Despite strict constitutional and statutory provisions, it proved impossible to assure adequately the redemption of term bonds by this method, for various devices were used to drain off the fund as it accumulated. When tax rate limits curbed the levies for current purposes it was possible to raid the sinking fund for payment of current bills. The Ohio laws authorized payment from the sinking fund of any judgment against the city except in property condemnation cases. When the monthly payroll for employees could not be met otherwise, a suit against the city would promptly result in a judgment that would be paid from the sinking fund.¹⁴ In other states the sinking fund was depleted in different ways. Purchase of the debtor government's own bonds may mean debt retirement, or merely the habit of borrowing from the fund as it accumulates, in which case the only security for one promise to pay is another promise.

STATE AND LOCAL DEBT EXPERIENCE AND MANAGEMENT UNDER DEPRESSION CONDITIONS

The statistics as to the volume of state and local debt and the rapidity of its increase indicate that prior to 1929 there had been a tremendous discounting of future taxable capacity and the resources for the support of debt. The expansion meant that there was certain trouble ahead if anything happened, and of course the very worst thing did happen, namely, the depression with its severe decline of incomes and capital values. In consequence, there were numerous defaults. There was also much discussion and some experimenting with solutions, and legislation that in some cases pointed toward stricter debt control, and in other cases toward moratoria and greater freedom of debt relief.

Defaults during the depression. Complete data on debt defaults are difficult to secure, both for lack of reporting and also because of a constantly changing situation. The default may be only temporary, it may

¹³ H. C. Adams, *op. cit.*, pp. 309-311.

¹⁴ *Report of the Ohio Joint Special Taxation Committee*, 1919, pp. 47, 48.

apply to interest only and not to principal, or it may apply to some, but not to all issues of the debtor government. In the summer of 1933 it was estimated that out of a gross municipal debt of \$18,500,000,000, about \$1,200,000,000 was in default,¹⁵ or about 6.4 per cent. Higher absolute and relative figures were later reached as the difficulties of tax collection increased. One state, Arkansas, was in default for a time, the reason being that the state had assumed responsibility for a large amount of local bonds.

It was natural that defaults should be most numerous in those sections in which the debt increase had gone farthest and fastest. Professor Ratchford has correlated local debt burden and defaults for this period with very interesting results.¹⁶ For the whole country, 1.68 per cent of all governmental units had been or were in default as of March, 1935. But in Florida, 44.5 per cent of all local units defaulted, while in Louisiana the percentage was 19.48, in New Jersey 14.80, Tennessee 13.53, and in North Carolina 11.96. On the other hand, no defaults had occurred in seven states. The debt situation stimulated attention to the question of the capacity of the various states to support debt, and various studies were made to build up indices of state ability.¹⁷ These studies in general confirmed the conclusion, which would be reached inductively, that the debt load is the primary factor in defaults. For example, New Jersey ranks well among the states according to the indices of wealth, personal incomes and business activity, yet the enormous debt, amounting to \$278.61 per capita in 1932, was sufficient to cause serious default difficulties, despite the comparative ability to support it. Florida alone then exceeded New Jersey in per capita debt, having \$337.74 in 1932, but her rank in the capacity to support debt was far below the median of all states.

The only effective measure of local debt capacity is the ability of the borrowing district to provide funds for debt service. A generalized state index of capacity cannot reflect all of the local variations of taxable resources within a state, and it may therefore, be misleading if used as a basis from which to infer anything regarding the debt capacity of a particular municipality.

Proposed debt solutions. As the depression grew in extent and intensity, various solutions for the local debt difficulty were considered, and some of them were applied. Refunding was an obvious remedy when the trouble was primarily the inability to pay maturing installments of debt principal. It was not always an available remedy without legislation, on account of the prohibition of refunding in the earlier legislation that had introduced the serial plan of local bond retirement. A number of states

¹⁵ *Municipal Debt Defaults, Their Prevention and Adjustment*, edited by C. H. Chatters, Public Administration Service, No. 33 (1933).

¹⁶ B. U. Ratchford, "State and Local Debts and Bond Defaults," *The Annalist*, November 22 and 29, 1935.

¹⁷ Cf. E. Trull, *Resources and Debts of the Forty-eight States*, issued by Municipal Service Department, Dun and Bradstreet, March, 1935.

made the necessary statutory changes,¹⁸ but the embarrassed local units could not always be certain of finding a market for the refunding bonds when authorized. Some states, notably New Jersey, obligingly purchased such bonds for various state trust funds when the market declined them. An effort was made to persuade the Reconstruction Finance Corporation and other federal agencies with ample funds at their disposal to absorb these offerings, but without success.

Another widely discussed remedy was the scaling down of principal or interest or both.¹⁹ This step could hardly be taken except by general governmental action, for no local unit could hope to accomplish it single-handed. It would have, of course, the same effect on creditors as would be produced by inflation, and had it been undertaken, the creditors ran the further risk of losing still more by a genuine inflation, since the federal government was then engaged in efforts to raise the general price level, a procedure that could be called "reflation" or "inflation" according to the point at which the advance stopped. The proposal is analogous to that of the so-called "multiple" standard for determining the equity of long-term payments, whereby the creditor receives at settlement an amount of purchasing power equivalent to that which he loaned.

The difficulties encountered by cities that sought to effect voluntary adjustments with creditors, because of the unwillingness of small minority groups to join in the debt reorganization plans, led to the extension of the federal bankruptcy law to local units, for a period of two years from the date of enactment.²⁰ It authorized local governmental units to prepare a plan of debt adjustment and submit it to the federal district court for approval.²¹

Comparatively little use has been made of this privilege, despite the belief that it would be found generally advantageous. No definite reasons can be assigned for the failure to undertake this procedure.²²

The use of scrip. One of the characteristics of the economic situation during a depression is the "freezing" of certain economic relationships. The decline of individual and business incomes prevents payment of taxes; the shrinkage of revenues prevents the local government from paying salaries and other local bills; and this loss of purchasing power on the

¹⁸ Cf. I. Tenner, *Municipal Finance Legislation*, 1935, Public Administration Service, No. 50 (1935).

¹⁹ Cf. S. E. Leland, "Governmental Debt Scaling: An Economic Complex," in *Municipal Debt Defaults*, pp. 43-54, for a general statement of the case for and against scaling.

²⁰ *Public No. 251*, 73rd Congress. Approved May 24, 1934. Cf. C. H. Chatters and J. S. Rae, *The Federal Municipal Debt Adjustment Act*, Public Administration Service, No. 41 (1934).

²¹ This act was rejected by the Supreme Court in *Ashton v. Cameron County Water Improvement Dist. No. 1*, 298 U. S. 513 (1936). A second enactment was described in the *Municipal Year Book* as a futile attempt to overcome the holding in the Ashton case. *The Municipal Year Book*, 1938, p. 64.

²² Cf. *Investment Banking*, Vol. VI, p. 68, November, 1935.

part of teachers and other employees impairs still further the ability of landlords and merchants to pay taxes.

Many varieties of currency substitute were tried during the early 1930's in an effort to break this vicious circle. The term *scrip* has been used to describe them. They promptly failed when the effort was extended to all sorts of financial relationships, for scrip could not be given legal tender power and hence could not serve as a general exchange medium. But when it was used locally, for the lubrication of the peculiar triangular relationship that embraced the local government, its employees and its taxpayers, some good results were obtained, although this outcome naturally depended on the general coöperation of all concerned.²³

Two years of experience with scrip in Cape May County, New Jersey, presents the system at its best. The results were thus described in the language of a press dispatch: ²⁴

Two years ago this county was "broke." It had plenty of book assets in the form of unpaid taxes due from municipalities. County and municipal employees faced payless paydays.

Cape May County employees have been paid promptly and every piece of scrip issued, it is estimated, has passed through at least three hands and has paid three obligations before it found its way back to a municipal tax collector, in payment of taxes, and was in turn sent by the municipality to the county in payment of county and state taxes.

The rapidity of circulation of scrip has made the interest item negligible and has saved the county about \$13,000 each year. As a result of scrip issues in 1933, tax collections jumped from 42 per cent to 100 per cent in 1934. This record was maintained in 1935.

Cape May County scrip is issued against two million dollars in accounts receivable and there is never outstanding scrip in excess of \$75,000.

Some general conditions essential to the success of scrip are apparent from this account:

First, the quantity outstanding must be limited.

Second, its use by the debtor government must be limited to the settlement of taxes. The Cape May County scrip was issued as tax anticipation paper, and was used initially to pay salaries and other local expenses. The process of tax collection assured its return to the county treasury.

Third, the community generally must accept it at par. Had the merchants and landlords insisted on discounting it, the local circulation would have been greatly reduced. General acceptance at par was determined by the restraint shown in the volume outstanding at any time.

Fourth, the scrip cannot be used as the sole medium of exchange or tax settlement. Its principal service was to "defrost" the frozen local

²³ Cf. *Municipal Scrip, A Report of Experience*, American Municipal Association Report No. 90 (n. d.).

²⁴ The New York Times, January 25, 1936.

accounts and payment transactions. As this occurred, the ordinary legal tender means of making payments were enabled to circulate again.

State receivership legislation. In 1931 Massachusetts inaugurated a method of dealing with financially embarrassed municipal corporations that was analogous to the established method of dealing with private business corporations that get into financial difficulties. This was the so-called "receivership." Two earlier experiments with advisory finance commissions had been tried, one for Boston, established in 1909 and one for Lowell, effective in 1926. Advisory authority was insufficient, however, as the results in Boston and Lowell demonstrated, and the action taken in the case of Fall River in 1931 was far more drastic. A board of finance was established, consisting of three persons appointed by the governor, of whom only one was to be a resident of Fall River. This board had complete supervision of the city's finances. It approved all appropriations and expenditures, and it had power to appoint and remove an auditor, a treasurer, a tax collector, and three assessors. Special legislation authorized the board to proceed with refunding, and to borrow if necessary outside the debt limitation in the process of adjusting the debt. Rigorous economies, especially in personnel and salaries, were instituted and some progress was made in debt reduction. Obviously only a politically disinterested agency, with ample powers, could deal effectively with such a situation.²⁵

Various other states have adopted a somewhat similar state municipal receivership policy. The plan presents an obvious advantage over the alternative of the federal bankruptcy law, since the latter provides no mechanism for the subsequent control of fiscal affairs, and therefore no assurance that the terms of a debt adjustment as agreed upon before the court will be executed. Continued mismanagement may make debt payment under the revised schedule difficult or impossible.

It is evident, however, that all of these measures are stopgaps only. The fundamental defects of local finance require for their correction the continuous supervision of a state department of local finance, in order that abuses such as have culminated in defaults, excessive taxes and general mismanagement may be prevented from appearing. Ultimately, also, there must be the kind of general overhauling of structure, functional allocation and financial methods that is outlined in the chapter on expenditure control.

One of the most effective measures yet devised for the protection of local credit and the prevention of debt abuses is the cash basis legislation enacted in New Jersey in 1938 and 1939. This legislation, which has been very effective in controlling local finances, has already been summarized in an earlier chapter (Chapter VIII).

²⁵ R. S. Van de Woestyne, *State Control of Local Finance in Massachusetts* (1935), pp. 120-140.

THE RESTRICTION OF STATE AND LOCAL DEBTS

The problem of debt limitation and control presents somewhat different aspects in the case of the state and of its local subdivisions, respectively. Experience suggests the desirability of some degree of control in both cases, but a wholly satisfactory technique of regulation has not yet been developed, although some progress has been made, particularly with respect to local debts. In general, the available methods of control are, by direct constitutional limitation, or by statute, or by administrative action, performed under the sanction of appropriate legislation.

The restriction of state debts. If the borrowing power of state government is to be limited or controlled, the only effective way is by constitutional provision. No legislature can bind its successors, and any statute of state debt limitation enacted at one session may be amended or repealed later. The earliest state constitutions did not deal with this question, but the state debt orgies of the early nineteenth century led to a wave of limitation amendments.²⁶

These limitations establish the amounts of debt which the states may incur, forbid the use of state credit in aid of any private enterprise, and provide for definite legal safeguards about such debt as is created. Borrowing for "casual deficits" is generally authorized, and for the protection of the state in time of war, for the suppression of insurrection or to repel invasion. No limits are set on the debts that may be created for these extreme measures of defense, although a common characteristic of these provisions is that all loans in excess of certain minimum amounts for any other purposes than those just mentioned shall have popular approval on a referendum vote. A number of states have recently adopted further amendments authorizing the issue of bonds for various purposes, such as the construction of highways, the payment of adjusted compensation to their citizens who served in the first World War, the development of water power, canals, and other projects. This relaxation of the limits on state debt has already caused a significant increase in the total, and further similar developments may be expected as the pressure upon the state governments increases.

The rise of the technique of fiscal control, described in Part V of this book, provides today a method of financial management that may offer a possible alternative to rigid constitutional debt restriction or limitation. This is essentially an administrative control, and it is obvious that the technique is no better than the capacity and intention of the men who apply it. There is nothing in the modern budgetary and fiscal control developments per se that would prevent a state administration from pil-

²⁶ Cf. H. Secrist, "An Economic Analysis of the Constitutional Restrictions on Public Indebtedness in the United States," *Bulletin of the University of Wisconsin, Economics and Political Science Series*, Vol. VIII, No. 1 (April, 1914).

ing up a huge state debt if such were the policy. It provides, however, an administrative procedure that focuses attention on the state fiscal processes, and it may, therefore, when properly operated, contribute to the illumination of the question of when, under what circumstances, and to what extent, the state should borrow in order to discharge its functions. A public administration that is intellectually and morally capable of utilizing the modern fiscal control technique probably needs no strict constitutional provisions on state borrowing. If this capacity is lacking, the only ultimate safeguard against the abuse of state credit lies in the constitution.

The restriction of local debt. The regulation of local debt is properly one of the aspects of the supervision of local finance.²⁷ The extraordinary shortsightedness displayed in the failure to develop the agencies and the technique of this supervision accounts for the use heretofore of rigid, mechanical and relatively ineffective methods of local debt control. The inadequacy of these methods is evidenced by the serious debt difficulties of many local units.

The constitutional provisions relating to local debt are summarized by Professor Secrist as follows:

1. The amount that may be created is limited generally to a definite percentage of the assessed value of the property in the district. In some cases this refers to the total property duplicate, in a few it is confined to the valuation of real property.
2. A maximum period is set for the maturity of the debt.
3. A referendum is frequently required on all bonded debt.
4. An annual direct tax levy is required for the payment of interest and principal.
5. Certain loans are not included in these limitations, while for other classes of loans definite extensions of the limit are authorized.
6. Prohibition of the use of local credit in aid of private enterprises.

The principal difficulty that is encountered in this method of regulation is its inflexibility. Constitutional provisions are necessarily rigid and unyielding. The proper use of credit involves a considerable degree of freedom and elasticity if the desired results are to be obtained while the interests of all parties, and of the present and future, are to be adequately safeguarded. For example, the establishment of a definite period for which all bonds may be issued almost inevitably means that the localities will use this period for all bonds regardless of the economic propriety of the policy. A limit of thirty or forty years would be proper for bonds issued to acquire park property, or other lands which would, in all probability, appreciate in value. It is entirely too long for highway bonds, or those issued to buy fire department apparatus. Flexibility may be secured by framing the constitutional provision to require adaptation of maturity to probable usefulness, but the details of this adjustment must be left to

²⁷ *Supra*, Chapter VIII.

statutory determination, so that the constitutional provision is no stronger than the law enacted under it.

Similarly, the use of the assessed value of property as the sole criterion of the amount of debt that may be created has signally failed, since the basis of valuation may be varied to meet the needs of the case. This basis was adopted at a time when the general property tax was the central feature of almost every state revenue system. The movement away from this tax renders such a coördination obsolete, while the retention of a number of independent but overlapping debt-creating authorities has resulted in a heavy pyramiding of loans on the same body of wealth. Sometimes four or five or six local authorities, each empowered to create debt, are levying on substantially the same mass of property in support of this debt. First of all is the county. Then comes the city, the school district, and finally, the park district, it may be, or the sanitary district, or both, and not infrequently other more or less independent organizations created for special administrative needs. A debt limit in relation to property means little unless it is comprehensive, but the multiplication of districts has really negated the original purpose of such restrictions. By the mere creation of new districts the debt load on any given mass of wealth may be steadily increased.

It is evident that no state can deal with all of the complications involved in local debt limitation and control by constitutional mandate. Nor is this possible by statute alone. Effective control requires properly drawn legislation and the supervisory services of a state agency such as a department of local finance.

Provisions of a local debt limitation statute. The legislation governing local borrowing should deal with such matters as the following:

1. *Limitation of purpose.* Aside from temporary loans made in anticipation of taxes levied, borrowing for current purposes should be prohibited. Tax anticipation loans should be limited to some percentage of the amount likely to be collected, as indicated by the recent collection experience, and should be repayable from the next ensuing collections after the issue of the paper.

As already emphasized, the need for tax anticipation loans will be diminished by synchronizing the tax collection and the budget years, or by providing installment payment of the local property tax.

2. *Limitation of amount.* The most serviceable basis for limitation of the amount of debt is probably the assessed valuation of taxable property, but the specific maximum of debt for any community should be subject to further restriction by the state supervisory agency inside the limit based on valuation. Emergency borrowing outside the limit should be subject to approval of this agency, and when such excess has been granted, all borrowing for any purpose should thereafter be prohibited until a margin of debt capacity has been established by amortization.

3. *Limitation of maturity.* All debt maturities should be restricted to the probable or reasonable duration of the property to be acquired or constructed. There should be a maximum limit of not more than twenty years for loans, regardless of the purpose of issue. Within this maximum a schedule of probable useful life for different classes of improvements should be established, and when two or more kinds of improvements are to be financed by a single issue, the maturities should be adjusted according to the scheduled useful life in proportion to the relative amounts to be spent for each. All expenditures for equipment or materials of any sort with a probable usefulness of less than three years should be declared to be current expense, for which borrowing would be improper.

4. *Limitation of proportion of improvement.* No loan should be permitted in the full amount of the expected cost of an improvement. In other words, there should be an initial down payment toward this cost, provided from current funds. Borrowing is a kind of installment payment plan, and a community that expects to operate under it should be able to make an initial cash payment.²⁸

5. *Limitation of method of redemption.* There should be universal enforcement of serial maturities, and refunding should be prohibited except as may be required in completing the transition to serial redemption. The law should forbid that the combined principal and interest payment in any year should exceed the total of any preceding year. This is necessary to prevent deferring much of the principal to the later years of the period with the danger that some part of it cannot be redeemed.

Serial redemption can be managed by appropriating a flat sum each year, of which the excess over the interest requirement is applied to the principal, or by appropriating a sum equal to the necessary aliquot part of the principal each year, as determined by the number of years to final redemption, plus the annual interest. The straight line plan equalizes the cost over the whole period, but it involves an appreciably greater total interest cost because of the relatively slower retirement of principal. It is therefore less desirable than the aliquot part redemption plan, on account of the greater cost and also on account of the failure to clear up the principal and thus provide margin at an earlier date for further borrowing within the debt limit if this should be necessary.²⁹

6. *Obligatory debt service taxation.* The law should require the annual levy and collection of taxes sufficient to provide for the debt service, and the application of the funds thus provided to this purpose.

²⁸ Massachusetts has enforced an initial cash payment of 10 per cent since 1924, and there has been a tendency on the part of towns, and of some cities, to increase this proportion voluntarily. Cf. Van de Woestyne, *op. cit.*, pp. 62, 63.

²⁹ For example, there would be a saving of \$52,000 in interest by retiring \$1,000,000 in twenty years by the aliquot part plan as against the straight line plan. At the end of ten years, \$500,000 of principal would be paid off under the aliquot part plan, but only \$393,150 would be redeemed under the straight line plan.

Administrative supervision of local borrowing. There is ample evidence to show that restrictive debt legislation alone will not prevent local abuses of public credit.³⁰ If the statute is self-operative, important provisions of the law may be disregarded. The refusal of the courts to enforce collection of local debts when the proceedings of authorization or issue have been irregular has compelled the bond-marketing agencies to give particularly close attention to these matters, to protect the investors. Without state supervision there is no agency to protect the taxpayers against the burden of unwise borrowing.

Further, no legislation of state-wide application, however carefully drawn, can be sufficiently flexible in application to keep the debt of each local unit within the bounds that are proper for it. This can be done only by an administrative agency, to which is given power, upon due consideration of the facts, to limit local borrowing inside the statute, and to pass upon the intensity of emergencies that would justify going beyond that limit.

Protection of the community against the unwise action of its officials may be provided by permitting the department of local finance to review bond proposals on the appeal of taxpayers in the district, or by requiring submission to it for approval all local borrowing projects before authorization. The investigation of local resources, local needs, local tax rates and tax collection experience, the existing debt burden and other elements in the situation should disclose whether, in view of the circumstances, the loan project should be approved or disapproved. Municipal officials naturally oppose this kind of regulation. Those who have acted prudently should have nothing to fear from it, while those who have been reckless should be curbed, in order that all municipal credit, and all municipal taxpayers, should alike be protected.

Federal taxation of state and local bond interest. The rule of immunity of state and local bond interest from federal taxation now appears to be so thoroughly established as to make the matter a closed issue. The revenue aspect is not important, for the federal gain would be at the expense of state and local taxpayers. The subject has been fully explored elsewhere, and those interested should consult the specialized literature.³¹

³⁰ Cf. Van de Woestyne, *op. cit.*, Ch. III; New Jersey Commission on County and Municipal Taxation and Expenditure, Report No. 2, *Municipal and County Debt* (1931).

³¹ Cf. H. L. Lutz, *The Fiscal and Economic Aspects of the Taxation of Public Securities*, New York, 1939; The Committee on Postwar Tax Policy, *A Tax Program for a Solvent America*, pp. 102, 103.

CHAPTER XXXIV

Some Effects of Public Borrowing

THIS CHAPTER will close the discussion of public credit by noting some of the effects of public borrowing. The term, *effects of public borrowing* is open to more than one interpretation. Since government borrowing is a means of providing expendable funds or purchasing power for the use of public agencies, the effects of using the funds that are acquired in this way are in one respect a problem of public expenditure. This aspect of the subject has already been examined.¹ In another sense, the significance of public borrowing lies in its relation to taxation. It redistributes the tax burden in time, lessening it for the present and causing a subsequent increase for the debt service. It also permits a public administration to engage in an expenditure policy or program without the necessity of disclosing its details or of canvassing its merit too fully before the people in a manner that would be unavoidable if the program were to be financed by taxation. There has been, in preceding chapters, a sufficient reference to these matters² and the effect of public borrowing on taxation will be passed over here, except as it may arise in connection with the question of debt redemption.

There remains what may be termed certain *merchanistic aspects* of public borrowing. The process results in the creation of a certain volume of assets for the financial community, since the government's debt obligations constitute assets in the hands of its creditors. The process is also likely to involve close relationship between the treasury and the banks, and it therefore touches at many points the problem of banking and credit policy. Moreover, its ramifications extend to the currency system, particularly when public debt obligations may be used to elicit or support credit or currency circulating media, or issued in a form designed to circulate as money, with legal tender power to liquidate private as well as public debts.

THE SOURCES OF BORROWED FUNDS

The funds that are obtained by public borrowing are drawn from the income or savings (i.e., past income) of the people, or they are created

¹ Cf. *supra*, Chapter IX.

² Cf. *supra*, Chapters XXX-XXXIII.

by manipulating the credit resources of the banking system. If the loans are sold to the people, the result is a diversion of purchasing power from the investors to the government. No net increase of purchasing power is involved and no marked effects are produced on the price level. On the other hand, government borrowing from the banks is done by creating new purchasing power in the form of bank deposit credits or bank notes. Such action is always inflationary, for it enables the government to enter the market with money to spend that has not been taken out of the current income of the people.

Since the one source of borrowed funds is non-inflationary while the other is definitely so, the question arises as to whether either source is always clearly to be preferred to the other. No positive, clean-cut answer applicable under all circumstances can be given, although it can be said that non-inflationary borrowing is the wiser and safer general rule. One exception to this rule that many would approve is that, to the extent budget balance is not maintained under depression conditions for any reason, the borrowing should be of the inflationary type in order to stimulate recovery.

It is true that an economic depression is characterized by liquidation, relatively low prices and diminished business activity, reduced bank loans and deposits—in general, a condition of deflation as compared with the boom phase of the economic cycle. Passing over here the question whether budget deficits are always necessary in a depression,³ the argument that the loans to cover the deficits should be placed with the banks with a view to providing an inflationary stimulus to recovery rests on the assumption that a deficiency of purchasing power is a primary cause of the depression. Hence, it is concluded from this premise, that the creation of more purchasing power will be a sufficient cure.

Granted that an expansion of credit would be a development favorable to recovery, its source and impetus are important in determining the degree of advantage to be expected. The most beneficial results are realized when the credit expansion is generated by the private economic forces. The theory that public spending will "prime the pump" and provide the initial impetus to these private forces was thoroughly exploited during the 1930's, but the results were disappointing. Some increase of business activity occurred, but there was never enough inner dynamic force to carry the recovery movement forward without the continued support of the deficit spending.

It is arguable that public borrowing and spending under depression conditions would be stimulative even if the loans were sold to the people rather than to the banks. If the economic machine has stalled on dead center, a prompt and decisive action, initiated either by public or private

³ Cf. H. L. Lutz, "The Case for a Balanced Budget," in *The Tax Review*, December, 1945, January and February, 1946.

agencies, might break the deadlock. The timing and use of the funds would be more significant than their source, in such a situation.

A prolonged period of deficit financing, whether occasioned by economic depression, war, or other adverse circumstance, is not likely to be met by drawing solely upon current income for the funds. Despite the obvious disadvantages of inflationary borrowing under all conditions, with the possible exception of those prevailing at the very depth of an economic depression, experience reveals that resort will always be had to the banks for a substantial part of the loan total.

The principal reason is that, in one way or another, it is possible to borrow more cheaply from the banks. The purchasing power represented by the income of the people came into existence through effort of some sort—work, savings, planning and risk-taking, and so on. Not being lightly come by, those who are asked to surrender a portion of their income to the government in exchange for its bonds or other promises to pay at some future date are not disposed to do so without an adequate reward in the form of interest. Hence debt financing from current income is always relatively costly as to interest. On the other hand, purchasing power created by the expansion of bank credit should, and ordinarily does, cost less. There is no deprivation involved, no one need forego the use of his own income, to supply the government need.

Such advantage as may be found in a "cheap money" policy is far more likely to be found in the political than the economic field. If the interest rates are high enough to induce the citizens to provide the funds sought by borrowing, the budget charges for interest on the debt will shortly advance to a level that will raise in the public mind questions regarding the benefits of the borrowing that would very likely be embarrassing to answer. On the other hand, when the interest rates are declining, as was the case after 1930, it is possible to hold down the budget item for interest despite the advance of the debt. For the time being it appears that much can be done for little. All of the evidences of a good bargain are present and the political appeal is on this ground. Just as the individual is persuaded, at times, that he is saving money in buying, at a bargain price, an article for which he has no need, so the nation is persuaded that it saves money in borrowing at a declining rate of interest even when there is no warrant for the deficits.

The mechanism of borrowing from the banks. The process of government borrowing from the banks is not different, in its essentials, from that by which individuals and business concerns use bank credit facilities. The bank acquires the government's promise to pay in the form of a bond, treasury note or certificate, and gives its own promise to pay in the form of a deposit credit. The transaction is, so far, precisely the same as in the case of a private loan. There are certain differences, however, that are the product of legislation designed to favor the government as

a borrower. In the aggregate this legislation constitutes a serious degree of interference by government with the normal processes and functions of the banking system, to its own advantage. Some of this legislation will be indicated as the discussion proceeds.

One legislative provision is of importance at the initial stage of the government loan from the bank. This is that the bank may be exempted from maintaining a reserve against government deposits, whereas this is necessary in the case of private deposits. At the moment of buying the government paper and creating corresponding deposit credits in favor of the Treasury, the operation does not diminish the bank's capacity to make private loans and thereby to create private deposits.

Government checking accounts are ordinarily maintained in the reserve banks, and the member banks which have bought public debt paper will eventually be called upon to transfer the government deposit balance to a reserve bank. This is done by forwarding a draft payable to the Treasury against its account in that bank. Unless the member bank has a free balance in its reserve bank account, that is, funds in excess of its legal reserve requirement, called an excess reserve, it must improve its balance position by rediscounting eligible investment paper, or by selling securities, to the reserve bank.

The process of bank credit expansion, once begun, tends to generate further expansion, although it requires, periodically, a new injection from some source. This may be illustrated as follows:

Assume, for example, that \$1,000 million in public debt paper is sold to the banks, and that the purchasing banks have free balances sufficient to cover the drafts issued to transfer the proceeds to government account in the reserve banks. As government disbursements are made, its checks are deposited in banks as private deposits. By the clearing process through the reserve banks the checks are deducted from government account and added to the remitting member bank accounts. Through this transfer, private deposits in banks will rise by \$1,000 million, and member bank balances in the reserve banks will show an equal rise. If the legal reserve ratio is 20 per cent, then \$200 million of the added balance must be regarded as part of the legal reserve against the increased deposits, while \$800 million becomes excess reserve. With this amount more debt paper can be bought, up to \$800 million, and the private deposit—excess reserve inflation will go on as before, though at a smaller figure arising out of the assumed transaction.

This particular credit inflation spiral would run down eventually. The top can be wound up for another spin by any device whereby member bank balances can be replenished. As was noted in Chapter XXXII, the flood of gold imports was the principal source of such replenishment from 1934 to 1942, and thereafter the expansion of federal reserve bank credit became the chief source.

Federal reserve open market operations. The term *open market operation* means the purchase and sale of securities or credit instruments by the reserve banks in the general financial market. Ordinarily the federal reserve banks are "bankers' banks," dealing with their member banks and not with the public, but the act establishing the system authorized open market transactions in certain types of credit instruments, including federal securities. These operations affect the member bank reserve accounts, purchases of acceptances or federal securities tending to increase member bank reserves and sales tending to diminish them. This can be made clear by an illustration of the process.

Assume, for example, that the Federal Reserve Bank of New York should buy \$2,000,000 of credit instruments in the open market. It would make payment by giving a cashier's check or draft on itself. The broker or dealer would deposit this check in his own account in a member bank, for instance the National City Bank, which, in turn, would forward it to the reserve bank, where it would be added to the National City Bank's reserve account. The National City Bank's individual deposits have been increased by \$2,000,000, which requires that its reserve be increased by \$500,000, or 25 per cent of this increase. The remainder of the \$2,000,000 that was deposited to its reserve account, or \$1,500,000, becomes excess reserve, which can be used to support additional private deposits or to purchase additional government paper for its own account.

The reverse of this operation occurs when the reserve banks sell securities or other paper. The purchaser pays with a check on his account in a member bank and the reserve bank charges this check against the member bank's reserve account, thereby reducing its balance. The reduction may be sufficient to wipe out any excess reserve which this bank may have had. According to the original theory of the federal reserve system, the reserve banks were expected to exert a substantial influence on the volume of credit by these open market operations. It is clear that if the sale of securities and the charging of checks against member banks' reserve accounts were to reduce these accounts below the required reserve minimum, the member banks would be obliged to restrict their loans or sell securities to, or borrow from, the reserve banks on approved collateral in order to restore their respective legal minimum reserve ratios. The restrictive effect of reserve bank open market sales is cumulative in that direction at the same rapid rate as is produced in the direction of expansion by open market purchases. Every dollar charged against the member bank's reserve account reduces manyfold the volume of deposits that can be carried, just as every dollar that is added to this account increases manyfold the quantity of member bank deposits that can be supported.

It would seem that there should be no significant difference, from the standpoint of fundamental banking theory, between the operations of

reserve and member banks in trade acceptances and other eligible commercial paper arising from private business and their operations in government securities. Whether it be government or private paper that is handled in the reserve bank open market operations, the effect on member bank reserves and lending power is the same. Likewise, whether the member banks lend to the government by buying its paper or to private business by discounting commercial paper, there is ultimately an expansion of member bank private deposits and a readjustment of reserve ratios at the reserve banks. Both types of transaction tend to increase purchasing power on a credit basis.

There are, nevertheless, some important differences in the results of the two operations, which arise in part from a difference in the character of the forces that create the two types of paper, and in part from the various ways in which the government has, by legislation, favored itself in its relations with the banks.

The force or motive that gives rise to the private demand for loan accommodation is the pace of private business, while the force that creates the government demand is an unbalanced budget, an excess of expenditures that can be met only by expanding loans. The banks are able to exert some restraining influence over the trend of private loans, but they are helpless against the government. In fact, the Treasury is in position to neutralize any effort that the banks might wish to make in restraining either private or public borrowing, for it is authorized to engage in open market operations in federal securities, using for that purpose the large stabilization fund that was created by the devaluation of gold or any other funds at its command. If the reserve banks should seek to restrict member bank credits by selling federal securities, the Treasury could offset this policy by purchasing securities. Furthermore, the reserve banks have not been free to engage in a sales policy with a view to restricting credit since the second World War began. On the contrary, they have been obligated, as a public duty, to support the banks. Hence the continuous expansion of reserve bank credit.

In the ebb and flow of business activity there is a steady tendency toward self-liquidation. If business is expanding, the maturing business paper is redeemed and a new, larger amount is created to carry the larger operations. If the business pace is slackening, a smaller volume of new paper is created as the maturing paper is paid off. The banking system, through its credit policy and its decisions as to discount rates, is able to stimulate loans in slack seasons or to restrain them if the expansion becomes too rapid. In the governmental operations under unbalanced budgets there is steady expansion with no possibility of self-liquidation or contraction. Therefore, while the essential mechanism of private and public borrowing is the same, the practical effects, so far as the banking system is concerned, may differ widely.

Danger of bank control by the Treasury. The inter-dependence that exists between the banks and the public treasury in the modern complicated credit economy does not require that the Treasury should control, directly or indirectly, the essential credit policies of the banking structure. On the contrary, sound finance requires that each member of this close affiliation should be independent of the other. Those who advocate government ownership and monopoly of all banking and credit institutions and facilities overlook or disregard the importance of providing adequate checks and balances. If the banks and the Treasury are in the position of two independently managed concerns that coöperate because of close mutual interests, there is a possibility for the exercise of an independent judgment on each side as to the steps to be taken and the length to which any program shall be pushed. A government monopoly of banking under treasury control would eliminate all chance of an independent check on treasury credit policy. The temptation for treasury manipulation of credit would be irresistible, and it would never be possible for anyone to know whether this manipulation was primarily inspired by the exigencies of government financing or by the requirements of the business situation. The present unwholesome relationship between the banks and the Treasury has been produced by an excessive degree of influence exerted by the latter, and by some unfortunate legislation. Complete control would produce a far worse situation, with no available means of correcting it. Instead of creating a government monopoly of credit, the federal reserve bank system should be completely free of government influence, so far as concerns policy. The Treasury might be, at times, its biggest and best customer, but there should be no behind-the-scenes control that would prevent the banks from judging the treasury program by the same standards that should be applied to any other customer.

There is no good case for treasury authority to enter the market to buy or sell government debt paper as a trading operation. Normally, it should never have cash balances large enough to do this on any substantial scale, except as a sinking fund transaction, in which case debt paper would be purchased, or taken up at maturity, and cancelled. A general authority to buy and sell in the open market is likely to be used principally to manipulate bond prices with a view to covering up, or counter-acting, the results of earlier mistakes of debt policy.

The influence of public expenditures. The growing demand for large public expenditures provides ostensible warrant for the encroachment of the Treasury upon the banking field and for the contention that government should own the banks. Enlarging public expenditure means greater dependence of the people upon government. Whether they are actually more dependent, or are persuaded that such is the case by the delightful sense of freedom from personal responsibility and initiative that is so

readily engendered by an obliging government, it is hard to say. In any event, the present temper and tendency of public administration everywhere is to accept, and even to seek, the opportunity for governmental expansion. With it goes, inevitably, greater governmental arrogance, a quick forgetfulness that public officials are public servants and not masters. There is increasing impatience with the restraints of prudent finance and greater inclination to disregard them. Having moved at last from millions to billions, the spenders now look forward to trillions. An enforced cooperation of the banks with the Treasury in executing the financial aspects of the resulting program is a significant result of the current trend in public expenditures.

Public borrowing and the currency. The term *currency* is used in two senses. One refers to all means of payment in general use, including bank deposits as well as metallic and paper money. The other usage limits the term to the coins and paper money manufactured by government agencies such as the mint and the Bureau of Printing and Engraving. Ordinarily there is a legal definition of the standard monetary unit in terms of either gold or silver, or both. In the United States this standard unit is the gold dollar, which now represents 15.9 grains of fine gold. All other kinds of currency—silver coins and silver certificates, Greenbacks, federal reserve notes, and bank deposits—have equal purchasing power because of a supposed relationship to the gold dollar. Prior to gold nationalization, in 1934, this equality or parity was maintained through actual convertibility into gold on demand. Since that time gold has been withdrawn from circulation and from private ownership, and the connection of other forms of currency with it has disappeared for all practical purposes, although gold may still be obtained for any other kind of currency, for export only, and with the consent of the Treasury.

Public debt operations influence the volume of currency, and hence its value or purchasing power. In earlier pages of this chapter the manner in which public borrowing affects the quantity of bank deposits has been outlined. Here the subject is continued by noting some of the further ways in which debt operations affect the volume and the value of the currency.

With respect to volume, the expansion of total purchasing power which occurs as government spending increases under the impetus of borrowing gives rise to a larger amount of coin and paper money in circulation. Payments are being made on an expanding scale to workers and others who do not have bank accounts and who tend to carry larger amounts of money in their pockets as money earnings rise. There is some hoarding of cash in safety boxes, and also some disposition, especially under high income tax rates, to keep transactions on a cash basis in order to avoid creating records that can be traced by tax authorities or law enforcement agencies. The tendency for currency in circulation to rise

as bank inflation proceeds may be illustrated by the data for selected years since 1930:

TABLE LX
MONEY IN CIRCULATION, SELECTED YEARS SINCE 1930 *
(MILLIONS OF DOLLARS)

<i>End of Fiscal Year</i>	<i>Federal Reserve Notes</i>	<i>Federal Reserve Bank Notes</i>	<i>Silver Certificates</i>	<i>Subsidiary Silver</i>	<i>All Other †</i>	<i>Total</i>
1930	1,402	3	387	281	2,449	4,522
1935	3,223	82	701	296	1,265	5,567
1940	5,163	22	1,582	384	697	7,848
1943	13,747	584	1,649	610	831	17,421
1945	22,867	527	1,651	788	913	26,746

* Source: *Annual Report of the Secretary of the Treasury*, 1944, p 777, *Treasury Bulletin*, January, 1946, p 83.

† Includes gold coin in 1930, silver dollars, United States notes (Greenbacks), national bank notes, and minor coin

The tempo of the increase of money in circulation has corresponded roughly with the rate of increase of the debt. Gold coin disappeared from use after 1934, and the national bank notes outstanding steadily diminished as they were received as bank deposits and retired. The sudden flare-up of federal reserve bank notes occasioned some criticism and objection on the ground that this paper was not adequately secured, and hence was unduly inflationary; but in view of the enormous expansion of the federal reserve notes, against which there was a gold reserve only in the technical sense, the objection appears to have been of minor importance. The plain fact is that for all practical purposes, all of the forms of money shown above are inconvertible, except that the silver certificates may be exchanged for silver dollars. In view of the extreme over-valuation of silver as money, such exchange would be of small benefit to the holder.

The value of the currency, or its purchasing power in terms of goods, tends to be affected by the relative supply of purchasing power and of goods, respectively. As already explained, large-scale public borrowing is virtually certain to involve, directly or indirectly, an expansion of bank credit. Hence it tends to the creation of a greater quantity of purchasing power, which finds expression in higher prices except as various controls may be established to prevent price increases. In short, credit expansion is an inflationary force.

The advance of prices registers the decline in the value of all forms of currency. If the debt increase is pushed far enough, the ensuing price inflation may attain proportions that would be tantamount to complete worthlessness of the existing currency, and likewise, of all obligations, public or private, that were payable in such currency. The devastating inflation and consequent destruction of values in various European coun-

tries after the first World War are potent reminders of the consequences of excesses in debt creation.

Complete destruction of debt through ruinous inflation does not always occur. Borrowing may be stopped before that point is reached, in which case a huge load of debt must be carried. A device for lightening the burden is currency devaluation. Resort to this device would be most likely in a period of depression, which is normally characterized, among other things, by falling prices. By reducing the metallic content of the standard monetary unit its purchasing power is lessened. Put in terms of the taxpayer, it would require a smaller quantity of his labor service, or his economic product of any sort to obtain a dollar with which to pay taxes, after devaluation, than it did before. The taxes required to pay interest or principal would therefore be less burdensome.

The taxpayer's gain in such a case is the bondholder's loss. The dollar which represents less of the former's economic effort will buy less in the hands of the latter. Moreover, the effects of devaluation would extend to all debtors and creditors, private as well as public. Inaugurated for the primary purpose of repudiating a part of the public debt, for this is what it involves, it ends by wiping out a part of all private investments also. Savings deposits, insurance policies, the endowments of hospitals, colleges, and other philanthropic organizations, are alike penalized.

Devaluation has had a long and disreputable record. Adam Smith referred to it in the following terms: ⁴

When national debts have once been accumulated to a certain degree, there is scarce, I believe, a single instance of their having been fairly and completely paid. The liberation of the public revenue, if it has ever been brought about at all, has always been brought about by a bankruptcy; sometimes by an avowed one, but always by a real one, though frequently by a pretended payment.

The raising of the denomination of the coin has been the most usual expedient by which a real public bankruptcy has been disguised under the appearance of a pretended payment.

During the 1830's the United States provided the one notable exception on record to Smith's generalization, for the federal debt, largely a product of the Revolution and the War of 1812, was completely paid off. But the circumstances were unusually auspicious. The government was not then undertaking to support the people, and there were no fiscal medicine men to preach the doctrine that a public debt is a public blessing.

THE EFFECTS OF DEBT PAYMENT

The mechanism of public debt redemption is in some respects a reversal of the operations that result in public debt increase. It is less

⁴ Adam Smith, *An Inquiry into The Nature and Causes of the Wealth of Nations*, Cannan Edition (1904), Vol. II, pp. 882, 883.

likely, however, to produce opposite effects of a magnitude similar to those produced by expansion, on account of the slower rate at which amortization ordinarily proceeds. The treasury funds for debt payment will consist of deposits in various banks, where they were accumulated during the process of tax collection. Debt repayment will be accomplished by the issue of government checks or warrants to the holders of the bonds or notes. Insofar as the depositary banks are themselves the owners of the paper that is redeemed, the repayment would result simply in a parallel diminution of the investment assets and the deposit liabilities. The operation would improve the reserve ratios of these banks if they had been obliged to maintain reserves against the public deposits.⁵

If one group of banks held the bonds while another group held the deposits to be drawn against for redemption payments, the effect of the retirement operation would be to strengthen the reserve position of the receiving banks and to weaken that of the depositary banks. The banks that received payment for their bonds would clear the government checks through the reserve banks, where they would be added to the reserve accounts of the remitting banks and charged to the reserve accounts of the depositary banks. Settlement of government checks through the reserve banks would deplete the depositary banks' balances and thus reduce the reserves available for private deposits. In some cases individual depositary banks might be obliged to build up their reserve accounts by restricting loans and hence deposits, or by other means such as the rediscount of eligible commercial paper. If the volume of private business were substantial these banks would have a supply of such paper, while if business were declining the shrinkage of deposits would cause the reserve depletion to be less embarrassing.

As between the two groups of banks, namely the depositary group and the bond-holding group (assuming for the moment that the two are distinguishable, which is hardly the case) the former would tend to experience a credit stringency on account of the drain on the reserve balances, while the latter would have larger reserves and would thus be in a favorable position for loan expansion. These tendencies would tend to cancel each other, and it is not clear that there would be any marked effect, toward either increase or decrease of the credit capacity of the entire banking structure as a result of the repayments.

When the government's payments are made to individuals, the effect for the banking system as a whole would be an expansion of private deposits and a decrease of public deposits. In the overall situation, no change of bank reserves is involved, but shifts may occur among the

⁵ Normally the banks are required to carry the regular reserves against government deposits. In 1943 an exemption was granted with respect to deposits payable to the United States arising solely as a result of subscription to war loans. This exemption was to expire six months after the close of hostilities.

several banks, constituting a reversal of the effects of the prior processes of tax collection. Tax payments, being mainly by check, had transformed private into public deposits. As these checks were cleared through the reserve banks, they increased the balances of the depositary banks while depleting those of the banks on which they were drawn. Later, as debt payments are made to individuals, member bank balances are increased while those of the depositary banks are depleted. Since the government, in retiring its debt, is operating on what it received from the taxpayers and cannot pay out more than has been received, the impairment of bank reserves due to debt payment should not exceed the improvement of these reserves previously occasioned by the tax collections. Among the several banks, however, the incidence of gain and loss in this respect may vary, as already noted.

Debt retirement and deflation. Public debt retirement is sometimes regarded as a deflationary process, one that tends to restrict the volume of bank credit and of credit purchasing power.⁶ It is therefore assumed to be an influence in the direction of lower general prices. For this reason it is urged that amortization should not proceed too rapidly.

The argument probably rests in part on analogy. It would be said that if the act of borrowing is inflationary, the act of repayment, being the opposite of borrowing, must necessarily be deflationary.

It is doubtful if the analogy is valid. Borrowing through the banks is a creation of purchasing power *de novo*. It can go on, as has been shown, without causing any diminution of private purchasing power, and it therefore results in adding to the total. From this fact springs the inflationary effect of the process of borrowing through the banks.

Debt repayment, on the other hand, is not the converse of borrowing in its effect on purchasing power. If it were, then repayment must destroy such power, inasmuch as borrowing through the banks creates it. This would be tantamount to compelling the banks to redeem the debts by a sacrifice of deposits. As a matter of fact, the retirement of debt is a transfer of purchasing power that does not affect its total. Taxpayers lose, while bondholders gain, in purchasing power, and so far as the debt retirement operation is concerned, the gain equals the loss. Funds are transferred from some persons to others, but in the aggregate the ability of the community as a whole to purchase materials or to employ labor is unaffected. Repayments to banks have the same effect as the repayment of any other loans which the banks have made. Their reserve position is improved and they are in position to extend credit in some other direction, if there be a demand for it.

⁶ For example, J. C. Stamp makes this statement: "Every repayment of debt represents a considerable force, making for deflation, in so far as debt is used as collateral security and forms a basis of credit. You withdraw such basis and the credit supported thereon shrinks with deflationary effects." *Wealth and Taxable Capacity* (1922), p. 179.

PART V

Financial Administration

CHAPTER XXXV

The Agencies and Instruments of Financial Administration

THUS FAR this book has dealt with various aspects of the two main divisions of public finance, which are the services assumed by or laid on government and the means of paying the costs of these services. Public expenditures and public revenues are the twin pillars of the structure. The capstone of this structure, tying expenditures and revenues together, keeping them in balance and preventing either from overshadowing the other, is financial administration.

In the broad sense, *financial administration* includes everything that has to do with the administration of the finances. Thus construed, it touches every detail of governmental operations, each of which will have its ordinary or technical service aspect, and also its financial aspect. For example, highways involve certain matters best handled by the highway department, such as the location of routes, the specification of construction according to traffic needs, the survey of grades, the acquisition of right of way, and the engineering task of laying the road materials. But they also involve financial administration in the provision and custody of funds, the determination of how much can be spent on highways, the recording of the amounts spent, the audit of claims and contracts, the appropriation and payment of money. Every other service of government is likewise touched and influenced by the activities of the financial administration as well as by those strictly pertaining to the service itself.

In this broad and comprehensive sense, financial administration is essential to the proper management of any unit of government, from the smallest borough to the national government. Throughout the field of government there is a consistent functional pattern of organization that includes certain essential aspects of the financial management function. These essentials are:

1. Planning and executing
2. Recording and verifying
3. Collecting and paying
4. Custody of funds

The meaning and application of these elements of the financial function should be fairly clear. No governmental unit, large or small, can

operate without some sort of plan or program. As a government it exists to perform services, few or many according to the circumstances; but it must proceed according to some plan of operation, however carefully or carelessly it may be shaped and executed. The money spent under this plan must be recorded and the records must be verified. Again the procedure may be exact or slipshod, but the essence of recording and verifying will be present. In order to have money to spend, taxes or other revenues must be collected, and finally, someone must take charge of these funds and disburse them.

In brief summary, this is the whole of government in its simplest financial management terms. The organization structure for accomplishing it may be rudimentary, as in a small rural township, or extraordinarily complex, as in a state or national government.

As outlined here, financial administration obviously embraces the function of revenue provision. In the discussion which follows, dealing with the structure and functions of the various agencies of financial administration, tax administration is omitted. This subject has already been dealt with in earlier chapters and repetition at this point is unnecessary. As will be indicated presently, there are reasons which seem compelling in favor of setting this branch of the general financial organization rather definitely apart from those agencies which deal primarily with planning, recording, custody and disbursement.

EARLIER INDIFFERENCE TO FINANCIAL ADMINISTRATION

Outside of the developments in the field of tax administration sketched in Chapter XIX, there has been comparatively little interest in this country, until recently, in other important aspects of financial administration. A treasury department was always provided, but its functions were generally limited to the custody of funds and to certain activities connected with tax collection, and in the case of the federal government, with tax administration. Accounting systems developed slowly and were inclined to stick in the ruts of routine procedure. Auditing was superficially done. Budgets are largely a development of the last thirty years, and some important aspects of financial control through the budget are as yet but little used.

Throughout most of the national history, federal and state legislatures were quite lax in the spending and raising of money, and whether any fiscal year ended with a surplus or a deficit rested entirely with the gods. The result was neither predictable nor determinable, and was therefore always somewhat of a surprise. No single authority had the power, under this characteristic earlier procedure, to coördinate expenditure and revenue and to keep the public finances in a balanced state. Although some efforts were made to improve tax administration, all branches of govern-

ment then lived in a state of innocence with respect to other important aspects of financial administration.

Under this primitive financial system, the public business, federal, state and local, was conducted in happy-go-lucky fashion. Appropriations were handled by one set of committees and revenue measures by another set, and they proceeded on the theory that since the right hand could never expect to learn what the left hand was doing, it was therefore useless to try. There were numerous appropriation committees, each of which laid its own expenditure plans without regard to the total expenditures for all purposes.¹ Each was beset by special interests seeking to obtain money to be spent in their benefit or to their advantage, directly or indirectly. The political slang terms *log-rolling* and *pork barrel* have long connoted the practices and the general attitude of legislative appropriation committees with regard to the public funds. While federal and state constitutions required that revenue bills must originate in the lower house, there was nothing to prevent the upper house from originating expenditure measures. Naturally there was never any assurance that the total of the expenditures authorized by the various independent and competing committees would be covered by the revenues provided.

The general framework of the revenue system of the states was rather rigid, while for the cities and other local units there was even less freedom in determining the volume of public income and therefore the expenditure program. In view of the methods that were pursued, the amazing thing is that general bankruptcy of federal and local governments was avoided. The author of the aphorism to the effect that the Almighty takes care of fools, children, and the United States of America had doubtless been studying the earlier history of financial administration in this country.

THE ESSENTIALS OF FINANCIAL ADMINISTRATION

The organization and equipment that will be required by any grade of governmental unit for the purposes of effective financial administration will naturally depend on its size and on the volume of its financial operations. With respect to these facilities, it is necessary to distin-

¹ In 1917 there were twenty-nine separate Congressional committees, fourteen in the House and fifteen in the Senate, preparing bills which carried demands on the Treasury. Ten of the House committees and eight Senate committees reported all appropriation measures, but the other committees had charge of matters such as pensions and public buildings, which called for appropriations to be prepared by some one of the appropriation committees. All of these committees were entirely independent of the executive branch, as well as the committees in charge of revenue. See C. W. Collins, *The National Budget System and American Finance* (1917), p. 52. The numerous appropriation committees have now been displaced by one central committee on appropriations in each house. Subcommittees study the various appropriation measures, which are then presented as reports from the main committee.

guish between (1) the agencies and (2) the instruments, of financial administration.

The agencies of financial administration. As used here the term *agencies* means the officers or agents who are needed for proper supervision and control of the financial operations, from the initial planning of the services to the final disbursement of the money. The legislative and administrative branches should be mentioned, since their participation is involved in the whole sweep of the financial function. The legislative and administrative functions are general, however, and include all phases of the governmental service. The reference here is rather to those special agencies that have to do primarily with the financial function as distinguished from other services or operations.

The character of these specialized financial agencies is suggested by the general nature of the financial function as outlined above. Every unit of government has certain financial agents which perform, in some fashion, the essential financial services. The wide range of needs according to size and volume of resources and responsibilities has produced equally wide variations in the administrative structure and the degree of logical completeness attained. Beginning with the simplest and most limited conditions, the list of these agents would include: (1) a treasurer or custodian of the funds; (2) an accountant, possibly only a bookkeeper, to keep the records of receipts and expenditures; (3) a planning and executing authority, which in the small local units is the governing body. (4) An auditor. The examination of claims before payment may be rudimentary and informal. The particular member of the local governing body who ordered work done or supplies delivered usually approves the bills before payment. The function of verifying the record of receipts and payments at the close of the year is now performed, in nearly all states, by or under the supervision of a state officer.

This extremely rudimentary financial administrative structure can be found only in the smallest local units. It has in it the essential ingredients, but the success with which it will operate, even in its proper small environment, will depend on the quality of the instruments provided for it. For the large cities, the states and the federal government a much more elaborate organization is required, but even at these levels the same essential ingredients are involved as are found in the financial administrative structure of the smallest unit. Obviously also, it involves more elaborate and complicated relationships. In other words, there is an essential unity about financial administration, regardless of the size or importance of the governmental jurisdiction. Similar basic principles apply everywhere. It is not something that can be enforced in one sphere and neglected in another.

At the state level the agencies of financial administration may be grouped as follows:

1. A department of finance, under which is established divisions of:
 - a. budget
 - b. accounts
 - c. purchasing
2. An auditor
3. A treasurer

This organization pattern is intended to indicate the agencies that are required. In exactly this form it may not be found anywhere, although some of the states that have adopted reorganization codes would probably come nearest to this general form. Tax administration is omitted, notwithstanding that it is an aspect of financial administration. The state reorganization codes have quite uniformly made the state tax administration a bureau or division under the department of finance, coordinate with budget, accounts and purchasing. This makes for logical arrangement but it has not always worked well as far as the states are concerned. The reasons for preferring a separate state tax department are the following: ²

The first reason for segregating tax administration and providing for it separately is that it is, in itself, a technical task of great difficulty and importance. It demands special and unusual qualifications, which, if present, usually mean that the equally specific qualifications required in other aspects of financial administration are lacking or not well developed. The tax administrator must deal with the citizens in a wholly different capacity from that of the service agencies of government, or from that of the public officers occupied with the other aspects of financial administration. Moreover, despite its internal diversity, revenue administration is a unity, in that it involves but one unified, consistent phase of public administration, whereas the remainder of the field of financial administration includes a variety of operations.

Second, the field of tax administration is so extensive that it may justifiably be set apart. The remainder of the field of financial administration will nevertheless be so large, with such a variety of complex problems, that there will be a real administrative advantage in the segregation.

Third, experience has shown that when administrative reorganization plans are laid out in accord with strict logic, with the tax administration relegated to its niche in the broad financial administrative scheme, it suffers first of all in the volume of appropriations, since it is thought of as a bureau rather than as a department; and being thus rendered financially impotent, it suffers also by loss of prestige, and by weakened authority to deal with taxpayers. As a result the whole financial basis of government is impaired.³

² Cf. the discussion of this general topic in *Proceedings of the National Tax Association*, 1923, pp. 263-288.

³ Cf. H. L. Lutz, *The System of Taxation in Maine*, Ch. IV.

Finally, there is danger that the advantage to be derived from the creation of a fiscal control agency such as a department of finance may be lost if this department must be responsible for the operation of an administrative task as extensive and complicated as that of tax administration. The major purpose of the finance department is to enable the executive better to coordinate and control the various operating services. If it must assume serious responsibility in tax administration, and this, it seems, would be unavoidable if the tax department is made a bureau within the finance department, the distraction may defeat, or at least gravely hamper, achievement of the primary objective.

The above schematic outline of the essentials of financial administration omits also another service which some think should be included. This is personnel administration. If the subject includes purchasing, why not likewise employment? As a matter of fact, the strictly financial aspect of personnel is included in what has been set down. In the preparation of the budget the rates of compensation and the total to be spent on salaries are subject to determination and control. Aside from the financial aspect of the compensation problem, the field of personnel management lies outside of finance. It includes selection and training, promotion, discipline and other matters. The financial results of governmental operation will be influenced by the skill or lack of skill displayed in dealing with the personnel, but this task is not a responsibility of the finance department.

The financial functions. A discussion in some detail of the financial functions is given in the chapters that follow. Here only a summary account is undertaken, by way of completing the outline and further defining some of the terms that are used.

The chief function of the department of finance is to aid the executive in determining and executing his policy of administration. The divisions placed within it are likewise designed to further this end. As the business of government becomes more complicated, the chief executive is increasingly unable to keep in touch with the operating departments that supply services. He needs an agency that can do this for him, one through which he can communicate his orders and instructions, and which can report to him what they are doing and how they are doing it. As will be seen later, he is responsible, in most jurisdictions, for preparing and executing a financial plan. The budget bureau is his agent in preparing the budget, or financial plan, and either this bureau or some other section of the department, acting under its head, must aid the executive in controlling the execution of the plan as approved by the legislature.

Further, the accounts and records of financial transactions are obviously essential to good administration. Since everything that the various administrative departments do must be done under definite legislative sanction and in strict compliance with the provisions of law, all authorizations of payments must be carefully checked against the appropriate

statutes. This is known as preliminary auditing, or simply as pre-audit. It is a financial control function and the officer who performs it is often known as the "controller," in both private and public business organization.

Centralized purchasing is regarded here as an adjunct of financial administration on account of the savings that may be realized thereby. The executive should spend his appropriations in the most prudent manner possible, and when centralized buying for all departments is more economical, only bad management would dictate another course. A further definite advantage of placing the purchase division under the department of finance is in the contribution which the data in its possession may make to the preparation of the budget. Tabulations and analyses of material and supply requirements may be very useful to the budget bureau in estimating future appropriation requirements for these purposes. Thus purchasing aids financial control, both directly and indirectly.

The auditor's function is that of review and examination of the accounts after the close of the fiscal year. This may seem to be useless duplication in view of the work done by the division of accounts and the controller, but the experience of both private and public management indicates the contrary. His examination is made from the standpoint of both accuracy or fidelity and legal validity. The auditor is not an agent of the executive, but rather an impartial critic of his acts and decisions.

The treasurer is primarily the custodian of the funds, and as such he is not an agent of the executive. Taxes and other revenues, as received, are delivered to him and checks or orders are drawn on him for the payment of the obligations incurred by the various departments and agencies.

The selection of financial officers. The general rule that should govern the selection of financial officers is that the executive should select or control the selection of those who are his agents, but not those who must be independent of him in the performance of their duties. This does not, of course, refer to the rank and file of employees, who should be selected under the merit system. The governor, for example, should select his commissioner of finance, who heads the department of finance, and he should have power to remove him at any time. Since the commissioner is to be, in so many ways, the governor's agent in the executive control of financial operations, the appointing and removing power should not be limited or qualified in any degree. Unless the principal have full authority over the agent, he cannot be held entirely responsible for the agent's acts. The modern tendency is to place full responsibility for financial management directly on the governor or the head of the administrative branch, and there should be no opportunity for an alibi if these affairs are mismanaged, as there would be if control over the commissioner of finance were limited.

The commissioner, in turn, should select the division heads under him, with the approval of the governor. They too are his agents, but the principle of direct line responsibility operates better if each responsible officer is allowed to select and control his own direct subordinates. If there would be any way of persuading a governor or any other executive that it is better politics and better business in the long run to select the head of the finance department on the basis of competence rather than of partisan favoritism, this would be desirable. A party organization which has only incompetents, or in which the administrative incompetents are so outstanding as to deserve the chief posts, is indeed bankrupt, in the moral and intellectual sense.

The nature of the auditor's work requires that he be not appointed by the executive. If the term is sufficiently long, as is the case with the Comptroller and Auditor General of the United States, there is no serious objection to an executive appointment, since such an officer, during his term, will be the critic of more than one executive, and under the law, the latter cannot remove him. In reality the auditor is the servant of the legislature, and through them, of the people. His term should always be fairly long, in order to free him from the recurring pressure to relax his standards and thus to curry favor.

As the size of the governmental unit grows, the extent of the treasurer's relations with the banking system increases, and the best preliminary preparation for this post is probably that provided in banking. His strictly custodial and disbursement functions are not under executive control unless so determined by legislation which makes the executive a participant in the selection of depositary banks, or some similar provision.

The instruments of financial administration. The instruments or tools of financial administration correspond to the various agencies, each of which has an instrument peculiarly its own. For the budget bureau there is the budget, for the auditor the audit technique, and so on.⁴ These agencies and their respective instrumentalities are not notably efficient when operated separately. Their maximum results are achieved, on the contrary, when they are utilized together. But it requires administrative capacity of a high order to coördinate the various financial activities so smoothly that their operation provides a means of guiding and controlling the service functions without at the same time hampering them with a mass of burdensome routine. Efficient financial administration, in other words, should be all-pervasive but, on the whole, unobtrusive.

In the chapters that follow there will be further discussion of some of the instruments of fiscal control, notably the budget and central purchasing, and also of some fiscal control agencies. In that discussion there will be no good opportunity for indicating some of the ways in which

⁴ Cf. the discussion of the instruments of expenditure control, above, pp. 97-99.

accounting may be used as a tool of fiscal control, and this is, accordingly, done here.

Accounting as a fiscal control instrument. The fact about the modern developments in accounting that renders it peculiarly useful for fiscal control purposes is its use as a means of yielding information concerning the operations with which it deals. The older purpose of accounting was to provide a check on the fidelity of those who had financial or other responsibilities. This is still important, but it has been discovered by modern business executives that the fidelity aspect of the accounts can still be utilized in full, while at the same time causing them to supply information of great significance to the administrator.

In order for this result to follow, however, it is necessary, as Willoughby points out,⁵ to know, or to decide in advance, the kinds of information desired, and then to cause the accounting system to be so set up as to yield it. The interesting and significant thing about accounting, the characteristic which makes it such a useful and flexible tool at the disposition of the administrator, is that when the accounts are designed to yield certain information, they will do it. Therefore, the first decision to be made, in installing or remodelling a system of public accounts, relates to the kinds of information wanted, the kinds that will be most helpful to the executive in shaping his policy of administration.

In doing this it must be remembered, however, that the administrator is not the only one who might conceivably be interested in the results produced by an accounting system designed to yield information bearing on the course of public policy. The general public, so often accused of ignorance and indifference, has a vast latent interest in government, and cogent, pertinent information about the processes and the results may be the spark that will effectively kindle it. The legislature may be, or at least should be, interested, especially during its serious moments with the budget and the appropriation acts.

It is not the purpose here to discuss, even in outline, all of the kinds of information that a properly designed accounting system might yield, or the kinds which the careful and conscientious executive should seek thereby as aids to fiscal control.⁶ It may be pointed out, however, that among other things, the accounts can readily be made to produce information regarding expenditures according to each of the classes suggested in Chapter III, namely, by function, character, object and so on. Further, by some development of unit cost methods, they can be made to produce an immense amount of data that can be used to formulate standards of cost, emphasized in Chapter VII as a basis for a policy of expenditure control. In view of the great possibilities of modern

⁵ W. F. Willoughby, *The Principles of Public Administration* (1927), Ch. XXXV.

⁶ An excellent treatise is F. Oakey, *Principles of Government Accounting and Reporting* (1921).

accounting, it is altogether surprising that public administrators have been relatively indifferent to it.

On account of the close interdependence of the various elements, it would be invidious and not altogether accurate to single out any one element as of greater or less importance than others. Accounting is important, though hardly more so, from the standpoint of assuring fidelity, than competent auditing; yet there must be accounts before they can be audited. Neither accounting nor auditing, both of which were used by governments long before the modern budgetary technique was introduced, provides effective fiscal control without a good budget system, as the earlier financial experiences of federal and state governments reveal. On the other hand, no budget system will operate well without proper accounting.

Despite this close interrelationship, the principal emphasis in the following chapters will be laid on the budget. In a certain sense the budget commands, by right, the center of the fiscal stage. It derives its strength from the other financial instruments, and they, in turn, exist in order to make the budget more effective. Moreover, the state of the budget reveals to the citizens and to the world the condition of fiscal affairs, and both the present and the probable future course of the tax burden.

CHAPTER XXXVI

The Budget

THE ABUSES committed under the earlier financial practices, and the efforts of various groups interested in financial reform together focussed popular attention on the need of some improvement. The increase of taxation as a result of the first World War induced greater popular receptivity to criticism of the former loose methods, and a wave of budgetary legislation passed over the country. The federal budget and accounting act was passed in 1921, and some sort of budget law has now been enacted in every state. Legislation dealing with this aspect of local financial procedure is also fairly common.

EVOLUTION OF THE BUDGET

The budget has evolved along with modern financial practice, and the term is not used in precisely the same sense by all writers, or in all countries. This evolution, as illustrated in English finance, is sketched by Bastable, who emphasizes the rudimentary character of the financial control that prevailed prior to the Revolution of 1688, and the necessity for the development of more adequate methods of supervision and control that subsequently existed.¹ As used by Bastable, the budget means "the financial arrangements of a given period, with the implication that they have been submitted to the legislature for approval." With the statement of receipts and expenditures is combined one or more legislative acts establishing and authorizing certain kinds and amounts of expenditure and taxation.

Stourm, a French writer on the budget, defines it thus: ² "The budget of the state is a document containing a preliminary approved plan of public revenues and expenditures." Willoughby applies the term to the whole series of steps involved in the financial operations of planning, collecting and spending: ³

It is the document through which the chief executive, as the authority responsible for the actual conduct of governmental affairs, comes before the fund-raising and fund-granting authority and makes full report regarding

¹ C. F. Bastable, *Public Finance*, Book VI, Ch. I.

² R. Stourm, *The Budget*, English Translation of the 7th ed., p. 4.

³ W. F. Willoughby, *The Problem of a National Budget* (1918), p. 4.

the manner in which he and his subordinates have administered affairs during the last completed year; in which he exhibits the present condition of the public treasury; and, on the basis of such information, sets forth the program of work for the year to come and the manner in which he proposes that such work should be financed.

The complete budget thus becomes a report on past achievements, a statement of the current situation, an estimate of prospective needs, and a proposal as to the means of providing for these needs. This report is usually prepared by the executive and his administrative heads who are responsible for the actual conduct of governmental operations and the management of revenues and expenditures. It is submitted to the legislature, the members of which are the representatives of the whole people, assembled to receive a report of the stewardship committed to the administration, and to approve or disapprove the plans for future work. Finally there is involved the idea of granting or withholding the funds necessary to carry out these plans.

Another stage should be added, in order to round out the modern conception of the budget and its plan in modern financial administration. This stage is characterized by Buck as "accountability for the budget as executed."⁴ It means, first, an audit of the financial operations under the budget, and second, a review of these operations by the legislative branch as a check on budgetary policy and executive methods. This review is not intended to supplant that which the executive should give as a preliminary of each budget when it is proposed, but rather to supplement it and thus to provide the legislative branch with a means of formulating its own views respecting this policy.

The development of budgetary practice is thus seen to be bound up with the rise of representative government. The people have control of the purse, in theory at least, and theirs is the power to open or close it. The executive and administrative officials who are the servants of the people, report in detail to the latter's representatives, the legislature. This body has been compared to the directorate of a corporation, to which the executive officials are responsible. In correct budgetary procedure the legislative function becomes that of review and criticism, with approval or disapproval of the results and the authorization of the proposed program after such modifications as it may be empowered to make. One book written during the campaign to secure a federal budget law advanced the thesis that the budget is the effective means for forcing administrative leadership, the responsible executive, to come before the people and the people's representatives with an account of past acts and a request for the approval of future plans. The budget thus becomes an essential factor in responsible government.⁵

⁴ A. E. Buck, *The Budget in Governments of Today* (1934), p. 47.

⁵ F. A. Cleveland and A. E. Buck, *The Budget and Responsible Government* (1920).

Budget procedure, as an aspect of the broader field of financial administration, is therefore the process of coördinating public outgo and income, and at the same time of providing for adequate and effective popular control over the actual business operations of the administration. If this conception of the scope and potentialities of the budget is to be realized, however, certain essential stages must be traversed. These are: (1) formulation of the budget; (2) authorization of the budget; (3) execution of the budget; and (4) audit and review of the financial operations performed under the budget.

FORMULATION OF THE BUDGET

Two questions arise with respect to the formulation of the budget. One relates to the authority that should be responsible for its preparation, and the other to its scope and content.

The budgetary authority. The modern practices of budget-making and the theory that has evolved concerning it, agree in providing that the budget should be prepared by the executive. The alternative, which is found in some states and cities, is preparation by a committee of the legislative body or by a group designated by the legislature to serve in this capacity. There are several reasons for preferring the executive as the agency to be charged with the preparation of the budget.

First, the data relative to the details of past and current operations of the administrative departments constitute part of the records of this branch and can be supplied only by it. While it might be urged that a legislative committee or some agency specially designated for budget-making other than the executive could readily enough obtain the necessary statistical and other information from the various administrative divisions, there would still be lacking the executive's estimates as to the future needs. The main purpose of collecting the results of past experience is that these may serve as a guide to the future requirements, and only the one actually responsible for carrying out the program can be really qualified to formulate a new one on the basis of previous experience.

Second, the advice and judgment of the executive are essential in coördinating the request estimates of the various divisions of the governmental service. The budget committee, it might be said, can secure from department and division heads their estimates of future requirements and thus arrive at a program for the future. This procedure would lead to rather undependable results, for it is well known that each such head has an extremely liberal notion of the importance of his own work and of the funds justifiably required for it. Some coördination, supervision, and pruning of departmental requests is essential, and no other governmental agency is as well qualified as the executive head to perform this basic service in budget-making.

Third, the nature of modern administration and financial operation is such that the executive must be responsible for the execution of the budget after it has been approved. It is therefore logical, from the standpoint of good administration, and from that of the theory of the balance of powers, to permit the one who must execute a program to indicate the character and scope of that for which he is to be responsible. If another agency is to prepare the budget, there is altogether too much opportunity for manipulation in the interest of political or sectional advantage, and too little assurance that the executive will be able to give expression to his own views and standards as to the governmental program.

The degree of authority allowed to the executive in making the budget naturally varies. In countries that have a parliamentary system with a cabinet responsible directly to the legislature, fairly complete powers over the budget are delegated to the cabinet, which is really the executive head of the government. On the other hand, the executive may be limited to the preparation of a preliminary financial plan, with supporting data. In this case the legislature will ordinarily reserve to itself greater freedom to modify the program, but there will be, even under such conditions, an opportunity for the executive to state his case.

As the business of government grows more extensive and complicated, it is apparent that the chief executive, such as the President of the United States, the governor of a state, or the Prime Minister of Great Britain, becomes unable, for sheer physical reasons, to master the details of the work of the several departments thoroughly enough to appraise accurately the significance of every part. When it is said that the executive should prepare the budget, the intent is that the actual work of collecting the necessary information, compiling and arranging the material, and putting the whole into the necessary statistical form, will ordinarily be delegated to a budget bureau or other administrative organ devised for the purpose. The essential fact is, however, that the compilation of the budget as a report on the finances is ultimately a responsibility of the executive, and since he is unable to give all details his personal attention, his ability to control the subordinates to whom certain phases of the public administration have been delegated becomes the more significant and necessary.

The chief executive cannot be held responsible unless he, in turn, is able to hold his immediate subordinates in the administrative structure responsible. The purpose of the state department of finance is to serve as a means of fiscal control in coördinating the various aspects of administration. The budget bureau, proposed as one of the divisions of that department, is the administrative arm directly responsible for handling all of the routine connected with the preparation of the budget, while the other divisions are designed to supply data of other sorts relative to actual operations which bear on the decisions that the executive must make,

both in the preparation of the budget and in its application as a financial plan during the fiscal year.

The situs of budget-making authority in the United States. The principle that the executive should prepare the budget is not universally observed in the United States. The federal government and more than half of the states have adopted it. The remaining states use some sort of board or commission, usually set up expressly for the purpose. The governor may be, but is not in all cases a member of this board. Under some types of local governmental organization, no differentiation exists between the executive and the legislative or ordinance-making branches. This is true under the board or commission form, found in nearly all counties, school districts and townships, and in a large number of cities. In all such cases, the budget is prepared, voted and executed by the same group. Only under the manager form, or the strong mayor-weak council type, is there an approach to a clear distinction between executive and legislative or policy-determining functions.

The states that have reorganized the structure of their administrative organization have taken, by this act, an important preliminary step toward better budget procedure. All of them have established some sort of fiscal control agency, although it has not functioned equally well in all cases owing to various local political handicaps. These new administrative codes have also furthered the general principle of executive responsibility by providing that the governor shall appoint the heads of departments, except as their election may be required by the constitution.

The policy of selecting various state department heads by popular election, found in a number of states, offers a possible obstacle to executive formulation and operation of the budget. These officials naturally consider that they are responsible directly to the people and the method of choice renders them independent of the governor. Indeed, they may be politically hostile to him and entirely willing, wherever possible, to hamper and discredit his administration. On the other hand, when the governor has adequate control over the execution of the budget, it would be possible for him to hamper the work of a politically hostile department head. From the standpoint both of the formulation and the execution of the budget, it is far better to have a unified than a politically divided administration. The success of all financial administration depends on the exactness with which executive authority and responsibility can be located, and the quasi-independence of separately elected officers is an obstacle to effective coordination. Another argument is thus offered against embedding unnecessary administrative details in the constitution, since they permit thereafter no flexibility of adjustment to changing conditions.

The Maryland situation is a case in point. A budget plan, excellent in many respects, was introduced by constitutional amendment in 1916. But

the constitution also provides for the election by popular vote of eight state officials. While the governor is empowered to require certain information from these officials in order to prepare his budget, they are in large measure independent of him. In addition, there is a marked degree of administrative diffusion, indicated by the fact that approximately one hundred and twenty different, independent commissions, boards, institutions and other agencies receive appropriations from the state. Much of the advantage that Maryland could have realized from the advanced budget plan of 1916 has been dissipated through the inadequate centralization of administrative authority.

As the executive type of budget has developed in the United States, certain general characteristics may be discerned:

First, there is, in nearly all cases, provision for a budget bureau, although it may be known by some other name, which is directly responsible to the governor and acts as his immediate agent in assembling and analyzing budget data.

Second, the executive is everywhere required to include in his budget without revision the estimates submitted by the legislative and judicial branches. This exemption from executive revision is based on the theoretical division of powers among coordinate branches. It has real significance only in those jurisdictions in which the legislature is not permitted to increase the executive's estimates. Yet in all cases it serves to save the face of the legislature and the courts, which are not required to haggle with the executive over the amount they are to be awarded. An unfortunate aspect of this restriction is the inability of the executive to criticize the nepotism and similar extravagances of the legislature, or the possible tendency of the courts to carry an excessive staff of hangers-on disguised as bailiffs and like minor officials. The Maryland amendment forbids the governor to impair the educational system, while in Delaware the governor is required to transmit the educational estimates without revision.

Third, the so-called executive budget, in the United States, is advisory only. That is, the legislature may use it as a point of departure in framing appropriation bills, but it is not necessarily bound by the estimates contained therein. This is in contrast with the English practice, under which the House of Commons does not undertake to propose increases in the budget as submitted. However, this does not mean, in England, a definite encroachment of the executive, for the English cabinet consists simply of a group of members of Parliament who have been selected to exercise administrative responsibilities. Their tenure as administrators endures only for such time as their policy is approved.

In the United States the legislative branch may increase as well as decrease items in the executive budget, except in so far as restraint may be set up by constitutional amendment. The prohibition against reducing judicial salaries during the term of office is of this character. Some states

provide for prior consideration of the appropriation bills required by the governor's budget, and in a few cases the separate appropriation bills, introduced by members and dealing with matters not covered in the budget, must carry with them the revenue measures necessary to support the expenditures, unless there is a clear surplus of unappropriated revenue in the governor's budget.

Fourth, the influence of the executive upon the revenue side of the budget is rather limited. This is particularly the case with local budgets, since the revenue system of local units is so largely determined for them by state law. They have minor local revenues, such as fees, fines, departmental earnings, and local license taxes, but their major revenue source is usually the property tax. Revenue flexibility in this tax may be sought by juggling the assessments, unless the taxpayers protest too vigorously. Normally, adjustments in the property tax rate provide the leeway required to keep the budget in balance. When tax rate limitations are imposed, serious local budget problems arise.

The President and the governors of a few states are authorized to make recommendations regarding revenues in their budgets. Nowhere are these recommendations in any sense binding upon the legislature.

The technique of budget preparation. Whether the budget is formulated by the executive branch, operating through a budget bureau, or by some other agency, a certain routine procedure will be followed. For the reasons already given, the results will differ in quality, though not greatly in form, according to the seat of the responsibility. Since the budget is to be presented to the legislature, the time of initiating its preparation will depend on the date of that session. For example, Congress now assembles in January, and the President's budget for the fiscal year opening the following July 1 must be ready for presentation then. During the preceding autumn the Budget Bureau will have notified all departments and spending agencies to submit estimates of their requirements for the new fiscal year, together with data indicating their expenditures to date in the current year and the probable requirements to complete this year. After tabulation and analysis by the bureau, the estimates are reviewed in conferences with the heads of the spending agencies on one hand, and with the President on the other. On the executive falls the ultimate responsibility of deciding how much to allow, and in reaching these decisions he must naturally rely heavily on the counsel and aid of the budget director. A similar routine of assembling and analyzing requests, of conferring with regard to them, and of modifying them afterwards as the responsible executive head may decide, is found everywhere.

The methods customarily pursued in making these decisions have ordinarily involved too great reliance upon past records and upon rather general impressions regarding needs, administrative capacity and the tax burden. It was pointed out in the chapter on expenditure control (Chap-

ter VII) that greater precision could be achieved in budgeting if the estimates were prepared by reference to standards of service and costs than can be hoped for when the records of past performance are the principal guide. A department or division may be overstaffed, or using obsolete methods, or giving inadequate service in relation to the cost for other reasons, but there will be no way of discovering these conditions by referring to its past expenditure records; nor will this discovery be made, save by sheer intuition, if general impressions are relied upon. Certainly the estimates or requests of such a unit would provide no clue whatever to its needs, judged by any objective standard of operating efficiency.

One of the duties of the budget bureau should be the accumulation of data by which to formulate working standards for the several services in order to provide a basis of independent judgment as to their efficiency. Otherwise, any budget will tend to grow, like a coral reef, by accretion. Each new budget tends to be built on an old one, and expenditure control is extremely difficult under such a policy. Without adequate standards, the legislative review is relatively futile, for the acme of legislative research is the committee hearing. This is an excellent device to develop a conception of policy, but it lacks the elements of scientific approach that are essential to a proper determination of how much to spend.

THE SCOPE OF THE BUDGET

As the budget comes from the executive it should be designed, in form and content, to accomplish two purposes: first, to serve as a report on the finances; and second, to submit a financial plan and program for the future. No standard form of the budget has been developed in the United States, but it appears that at least three parts or sections are essential if the two major purposes mentioned here are to be adequately served.⁶ Part I should be a budget message, or compact general summary; Part II should present in detail the comparative data, the estimated requirements, and the other statistical material required to support or explain the financial plan; and Part III should contain drafts of bills designed to give effect to the plan prepared. The purposes of reporting and planning are served in summary fashion in the budget message and in detail in Part II, which is the main body of the budget document.

A report on the finances. The budget message or summary, in Part I, should review the general results of financial operations during the last fiscal period and also during that part of the current period for which actual data or dependable estimates are available. In summary fashion, with a minimum of statistical detail, the executive should indicate the manner in which the plans set up in previous budgets have worked out

⁶ A. E. Buck, *Public Budgeting*, pp. 55 ff.

both with respect to revenues and expenditures. This characteristic of the budget as a report is carried over into Part II, where detailed comparative data for previous years are shown in parallel columns, together with the appropriations for the current year and the amounts requested for the ensuing period. Thus, in summary and again in detail, the budget reports on financial operations and results, and so becomes a guide to the next program to be formulated.

A financial program. The program for the future is likewise indicated in summary in the message and in detail in the body of the document. The need of providing a clear, compact, interesting and informing statement of the results and the plan makes the budget message a very important part of the whole. No governmental unit is too small to warrant the neglect or omission of this feature. It is impossible to expect that the citizens generally will study the mass of statistical detail contained in Part II; indeed, it is unlikely that all legislators will do so. The message becomes, therefore, the medium through which is conveyed the general significance of the achievements and the plan. It should contain a compact tabular summary of the finances, classifying revenues by major sources and expenditures preferably by functions, since the people are likely to be more interested in what government is doing than in any other aspect of expenditure classification. The past results and the anticipated program can thus be set out together.

One great advantage in requiring or permitting the executive to formulate the budget is that his advice and judgment are thus utilized in planning any changes of policy that may be considered essential. Former expenditure purposes may be reduced or eliminated; new purposes may appear; and the relation of revenues to expenditures may indicate the need of further taxation, the possibilities of tax reduction, or the obligation to increase the public debt. If it has been possible to base the estimates upon standards of service and cost their value will be greatly increased, for the program can then be discussed in terms of what it proposes to provide in services rather than simply as an expenditure of so much money which has to be provided by taxation or by loans.

However the program may be arrived at, there are certain conditions that should be met if the budget is to be regarded as adequate. The scope of the budget must be viewed from the standpoint of: (1) the character of the program; (2) its comprehensiveness; and (3) its extent in time.

The character of the program. The first requirement is that the budget should include both the current operations and the capital outlay program. The omission of the latter feature is a common defect of budget making as now practiced, but it is obvious that a proper view of the financial program is impossible if the expenditures for capital improvement purposes and the proposed means of financing the expenditures for these purposes are omitted.

One reason for this omission is that not many governmental units undertake to formulate long-range plans for their capital improvements. They may plan the current operations carefully, including the month-by-month and year-by-year expenditures for salaries and wages, fuel, supplies, and all of the current needs and activities in every line. But the new buildings, the new roads and streets, the new sewers, and all of the other expenditures on capital improvements with a relatively long life of useful service are ordinarily not brought into the budget picture. Government planning of this comprehensive nature is not easy; it involves forethought, which some people lack, and prudence, which conflicts with the hand-to-mouth philosophy of ordinary politics. It requires that the probable future needs of the governmental unit for additional large improvements of every character be set down in the probable order in which they must be provided as the years pass.

Such an improvement program cannot be rigid, for changing conditions may require modification. But even so it is a better indication of the future large commitments which the taxpaying community faces than no program would be. The objection to improvement planning that many public officials offer, namely the uncertainty of the future, is not at all valid, since such planning is never in the nature of fixed distant commitments, but simply a means of dealing more intelligently with improvement needs as they become definite. This wider horizon of needs should induce greater prudence in dealing with each year's capital expenditures.

There should be, therefore, a dual plan, one aspect of which relates to the ordinary current program and the means of financing it, and the other to the capital improvement program and the proposed means of financing it. To the extent that the improvements are to be paid for by borrowing, the contemplated loan program for the year is thus clearly set out, with its effect on the debt situation and on present and future tax levies.

Comprehensiveness of the budget. The budget should be comprehensive in the sense that it should include all of the revenues to be received and all of the expenditures to be made. The inclusion of the capital improvement program is one aspect of this subject; another, and the one especially stressed at this point, is that it should include all tax and other receipts, although collected for specific purposes, and should make provision for all of the spending on specific as well as general purposes.

The subject deserves emphasis because of the tendency of legislatures to impose certain taxes for definite purposes, then to earmark or "dedicate" the receipts to these purposes. Having done this, the money is delivered directly to the spending agency and thus removed from any executive control, while the spending agency too often considers itself absolved from any responsibility regarding its disposition of the funds received other than to spend them on the designated purpose.

The assignment of fuel tax and motor license revenues to the highway departments has been, in many states, a prominent case in point. Originally developed to finance highway construction and maintenance, these revenues often never appeared in the state budget, which of course did not deal with the highway program and expenditures. One result of this policy was not infrequently inordinate costs of highway construction, and an excessive concentration of funds on the limited mileage in the state system instead of more general diffusion of the funds over the entire highway network.⁷

Other instances of failure to budget receipts and expenditures are in the earnings of departments, the operations of licensing and examining boards, and the use of fees to reimburse various officials.

It is now generally agreed that there should be no dedication of particular revenues to specific purposes. It is apparent that this policy would interfere with comprehensive planning of governmental needs and of the means of supplying these needs. The argument that there should be a definite tax to support roads or schools or some other service makes a strong appeal, especially to those interested in the particular service. It should be evident, however, that the yield of a particular tax can never be, save by sheer accident, the proper measure of what should be spent on a particular service; and that if such a procedure were generally followed, some services would be maintained in luxury while others starved. Its effect on the competition among departments for the productive taxes can well be imagined.

On the contrary, all receipts and all expenditures should pass through the budget. The relative needs of all services should be weighed and considered in preparing the financial plan and the available funds distributed among them. If there is, anywhere, peculiar force in the contention that a certain tax exists in order to provide for a particular service, the budget plan could propose appropriation of substantially the amount anticipated from the tax. Budgeting would definitely fix responsibility, would assure recurring review and appraisal of this policy, and would be the only means whereby its wisdom could be effectively judged.

In addition to the general government and its activities, there are many types of governmental enterprise of a more or less commercial character. Good management demands that the receipts and expenditures of each such undertaking be carefully budgeted. So far as their financial relation with the general government is concerned, their receipts and expenditures may be handled as part of the general budget, or under separate budgets which are tied into the general budget by reporting

⁷ Cf. the discussion of the situation in New Jersey under a system of dedicated funds and unbudgeted highway expenditures in *A Report on a Survey of the Administration and Expenditures of the State Government of New Jersey* (1932), Ch. VIII.

there simply surpluses and deficits, or by effecting complete separation under an entirely independent budget.

All of these methods are used, but Buck concludes that the second, that of separate budgets with the final financial results reported in the general budget, is best adapted to American conditions.⁸ This conclusion seems sound. The experience of the Panama Canal, which is operated under the first method, indicates that as a general policy the result would be very unfortunate. All receipts are covered into the Treasury and all expenditures are proposed in the general federal budget and authorized by Congressional appropriation. Efficient administration is thereby hampered. At the other extreme, it is doubtful if many government enterprises could maintain complete financial independence in view of their perpetual need of general appropriations to cover deficits in operation. The method of the annexed budget, as it is called, permits flexible independence of administration of the enterprise, including the retention of such part of the net earnings as may be justified for development purposes, but the reporting of surplus or deficit in the general budget reveals to all the actual results of the management.

In 1945 all federal government corporations were brought under supervision for the first time with respect to budget and audit control. Prior thereto the situation had bordered on the scandalous. A survey published in 1943 revealed that 32 of these corporations were not subject to audit by the General Accounting Office, while in the case of 9 others, only partial accounts were submitted. None of them had ever submitted budgets to the Congress. Under the 1945 act, each corporation is required to submit a budget annually and to have a complete review of its accounts by the General Accounting Office.⁹

The extent of the budget in time. The time duration of the budget must naturally be adapted to the practice of the legislative body with respect to its own sessions. For all accounting and administrative purposes, public as well as private, the fiscal year basis is used. This may be the calendar year or any other twelve-month period. If the legislature meets annually, the budget will normally cover one fiscal year. If less frequent sessions are held, the budget obviously must cover two or more fiscal years, as the case may be.

Whether every detail of revenue and expenditure legislation should be subject to annual or periodic consideration is a question on which opinion is somewhat divided. In general, the main outlines of the revenue system are not likely to be modified year by year, and the bulk of the tax laws should be considered as permanent legislation, although some of the tax rates may require adjustment occasionally to assure a balanced budget.

⁸ A. E. Buck, *The Budget in Governments of Today*, pp. 152-154.

⁹ The Citizens' National Committee, *Government Corporations. The No Man's Land of Federal Finance*, Washington, 1940.

Permanent appropriation acts are likely to cause more trouble, since the circumstances that gave rise to them originally may change, and, as has been the case in the federal experience, they may run on long after everyone has forgotten them or the reasons for their enactment. This would not be true of appropriations to the sinking fund or for interest on the public debt, but the specific amounts for such purposes should of course appear in every budget.

EXPENDITURE CLASSIFICATION IN THE BUDGET

In Chapter III the value of expenditure classification as an aid to budget-making was stressed. The whole purpose of a scheme of classification is to provide greater clarity and definiteness of information than can otherwise be secured. As already indicated, the public generally is probably more interested in what government is doing than in any other aspect. Hence a functional classification will doubtless receive more attention than any other.

The facts that are presented should be organized, however, with a view to revealing, not only what services or functions the government is performing, but as well what governmental agencies or organizations are responsible for the actual performance of certain duties. For example, it is important to know how much the state is spending for education, for the construction and maintenance of highways, for the protection of life and property, for health and sanitation, and for the various other functional activities which it has undertaken. It is also necessary to know to what extent the department of education, or some other agency is responsible for the expenditure of the money devoted to education, and so on through the list of departments and agencies. The money is spent for certain purposes or governmental functions, but it is spent by certain departments, bureaus, divisions or other organization units. It is necessary to know the cost of a given policy, which calls for a report in terms of functional activities; it is also necessary to be able to fix definite responsibility for expenditures, which requires a report of expenditures according to the spending or administrative units. From the standpoint of the evaluation of public policy, the classification according to functions is more important; while that based on the administrative units is of greater significance from the practical standpoint of definite fixation of responsibility for the costs of these policies. The two viewpoints can be combined by devising an administrative organization based, as far as is practicable, on a functional analysis of what the government is doing. The expenditures for education would then be made by the department of education; those for highways by the division of highways and so on.

Other checks upon the results of the administration may be provided by further classification and analysis of the information contained in the

budget. Object and character classification are both illuminating and worth while. The former refers to the specific types of goods and services brought in building a highway, for example, while the latter has reference to the distinction between current expense, fixed charges, the acquisition of property or the redemption of debt. The more complete these details in the analysis of the expenditures and the proposals for the future, the more accurately may the efficiency of the administration be tested. The classification according to expenditure objects will prove useful in making comparisons on a cost basis, and will further the development of standards of cost. That according to character will emphasize the distinction between current and capital operations and the importance of budgeting both types of expenditure with equal thoroughness.¹⁰

POPULAR UNDERSTANDING OF THE BUDGET

While the technical and legal aspects of preparing, authorizing and executing the budget are matters within the domain of the officials and the legislative representatives of the people, the essence, and substance of it should be made available to the people themselves. The legislature is the body having the constitutional authority to enact laws, and its formal approval is required to give final validity to administrative acts. But the legislature is not the ultimate seat or source of sovereignty. Back of the legislature are the people, too often but dimly aware of the processes of government, and frequently unable to fix with certainty the responsibility for efficiency or inefficiency in public administration. The executive renders, through the budget, an account of his stewardship to the legislature; he should also present his accounting to the people.

The failure to develop the means and the technique of presenting and interpreting to the people the significant facts of governmental operations and their cost, as set forth in the budget, is one of the more serious defects of budgetary procedure everywhere. This short-coming becomes especially significant in the United States in view of the cherished traditions of democracy. Some states require that public hearings be held during the course of the preparation of the budget, but, at best, the number of persons who would attend such hearings is small. In certain states the governor is required simply to publish a sufficient edition of the budget to provide each legislator with a copy.

This suggestion does not involve more public hearings or a larger edition of the complete budget. In its complete form, such a document would be meaningless to all but a select few. Nothing is so terrifying to the average person as a mass of statistics, and information provided in this form only, or accompanied simply by a formally correct but un-

¹⁰ For a more complete discussion, cf. A. E. Buck, *Budget Making*, Ch. VII. See also, above, Chapter III.

interpretative explanation of the details, produces but a slight impression. Certainly, it accomplishes nothing to promote understanding. The material contained in the budget may become the means of quickening popular interest in government, and thus of vitalizing democracy. One of the most significant objects of the budget, which is the exercise of popular control over the policy of government and over the public servants, is defeated if the public is not able to comprehend the report as presented, or is discouraged from seeking further light by its formidable aspect.

On the contrary, the report should present simple, popularized accounts of what government is doing and how it is being done, based on the budget data. For a few days after a budget is published, its outstanding features are "news" but the press soon turns to other things. The correctly prepared budget is a mine of information on the achievements and the plans of the government, but its resources as a means of educating the people about government are too often neglected.

THE AUTHORIZATION OF THE BUDGET

The second stage in the life cycle of the budget is submission to the legislature and action upon it by that body. This step was eliminated under the dictatorships, and the budget as prepared by the dictator-executive became effective without the formality of consideration and approval by the representatives of the people. Sometimes, when the tedium of legislative debate, the exhibitionism and the insincerity of individual legislators reach a climax, the wish is expressed that a strong dictator could replace the lot. The frying pan of democracy is very much cooler, however, than the fire of dictatorship, as was discovered by those who made the leap.

Legislative action on the budget. The formality of submitting the budget to the legislature may be such as to invest the proceeding with color, dignity and the elements of drama, or it may be a routine and lifeless affair. In England the budget speech, made by the Chancellor of the Exchequer, presenting and analyzing the financial plan, always arouses great interest in and out of Parliament. In the United States it is likely to be a routine rather than an exciting event, although it would be possible to dramatize the presentation by reading the message personally before a joint session, with arrangements for radio broadcasting.

The procedure of the legislature and the extent of its action on the budget will depend somewhat on the policy pursued with respect to the budget authority of the executive. In England, where the cabinet consists of members of the House of Commons, the budget requests are treated as maxima and action on them in Parliament is therefore limited to approval or modification downward. In some American states the governor's budget requests are likewise to be considered as the maximum amounts to

be voted, but this limitation on the legislature has always been established by constitutional amendment.

On the other hand, the budgets of the federal government and of a large proportion of the states are regarded as advisory only, which means that the legislature has authority to increase as well as decrease the amounts requested. Under such circumstances the executive's ability to influence the fate of his budget, once before the legislature, will depend upon his influence and skill as a party leader. In this respect American executives are at a disadvantage as compared with the English cabinet. As members of the Commons, the cabinet members not only frame the budget, but participate in the discussion of it. Naturally, they are able to influence, if not to control the course of the action taken on it. No American executive has the privilege of appearing before the legislature except by its consent, and his participation in legislative discussion, even of the matters that he had recommended, would be regarded as highly improper. It becomes necessary, therefore, to accomplish through the back door and by hidden means what cannot be done openly by way of the front door.

How the budget is acted upon. In the United States the budget as such is not a project of law. It is a report and a plan concerning the finances and no legislative action is directly taken with respect to it. An exception is found in some of the smaller municipalities, where the budget is a rather simple affair and where it is before the council both as a financial plan and as an ordinance to be enacted after such amending as may be decided upon. As an ordinance it also carries the rate of property tax levy which is shown to be required, and hence it is sometimes spoken of as the "budget and tax ordinance." Among the larger governmental units, however, no budget can serve both purposes, and the legislative action is upon revenue and appropriation bills rather than on the budget. It is approved if these measures are designed to bring results that are in harmony with its proposals.

Again comparison with the English procedure may be instructive. There the budget is passed upon section by section ¹¹ and so it is "voted" in a very real sense. The amounts thus passed by chapters or "votes" are again authorized in appropriation bills but there is an actual and definite preliminary legislative action of approval on the budget itself.

The bills necessary to give effect to the budget may be drafted and submitted as Part III of the budget, but this is a rather uncommon practice, and if it is done the result would be regarded as a kind of bill-drafting service which might or might not be welcomed by the legislature. Submission of such bills as part of the budget would not constitute their introduction as legislative measures, for only the members can introduce

¹¹ The several main divisions or sections are called *votes*. In the French budget they are known as *chapters*.

bills; and unfortunately for the quality of legislation, every member has this privilege.

Before the financial plan embodied in the budget is considered by the legislature, it is referred to appropriate committees. The committee organization of Congress has now been greatly simplified over the chaotic condition prevailing prior to the enactment of the budget act. Each house has a single committee on appropriations. The House has a committee on ways and means, and the Senate has a finance committee for the consideration of revenue measures. Since revenue legislation must originate in the lower house, under the constitution, appropriation bills have been permitted, by custom, to originate there also. The result is that the Senate defers action on budgetary matters until after the House has acted.

The committee on appropriations acts upon the expenditure proposals of the budget; while those involving revenues go to the committee on ways and means. Each committee is divided into sub-committees. The House appropriation committee has eleven subdivisions, one for each of ten major appropriation bills and one on permanent appropriations. The Senate appropriation committee has a parallel sub-committee organization, except for the one on permanent appropriations.

A noteworthy suggestion was offered in 1946 relative to closer Congressional control over the budgeting process.¹² It was that, by joint action, the revenue and appropriations committees of both Houses should submit, on or before April 15, a concurrent resolution setting overall federal receipts and expenditures (estimated) for the ensuing fiscal year. If the total expenditures recommended should exceed estimated income, Congress should be required by record vote to authorize the creation of additional federal debt in the amount of the excess. In case the total appropriations subsequently voted should exceed the approved budget figure, all should be reduced by a uniform percentage except permanent appropriations, and those for interest and debt retirement, for veterans, and for trust fund expenditures. This is a drastic, but highly salutary proposal. It is drastic because the record vote in favor of increasing the debt to cover spending in excess of revenues would put every member definitely on the spot, whereas they would much prefer the anonymity of a voice vote which would not fix individual responsibility.

The Congress did not go as far toward fiscal control as the foregoing proposal had suggested. However, an act was passed (Public Law 601, 79th Cong., 2d sess.), which provided for a joint committee statement on expenditures and revenues, called a "legislative budget." This report is to be made by February 15 of each year. The president has no authority to reduce expenditures under the appropriations as voted. Provision is made for an increase of the debt, to be authorized by concurrent

¹² *Report of the Joint Committee on the Organization of Congress*, 79th Congress, 2nd Session, Senate Report No. 1011, March 4, 1946.

resolution, if the expenditures should exceed anticipated receipts, but the manner of voting on this resolution is not specified.

The entire committee organization of each House was extensively modified by this act, by reducing the number and consolidating the functions of the numerous previous committees. This improvement will facilitate the conduct of Congressional business and thus will contribute to a better management of the finances.

The form of appropriations. The form and detail in which appropriations will be voted will depend on the degree to which the legislature may insist upon retaining for itself strict control over the manner in which the money is to be spent. The two extremes of this policy may be designated as the "line item" and the "lump sum" methods of appropriation, respectively. Under the former, each line, or at most each paragraph, of the appropriation act provides a definite amount for a specific purpose, as for a clerk's salary or for the purchase of a truck. In such case the money is authorized to employ a clerk or to buy a truck, but for nothing else. The executive has no discretion about spending, except to do it in the detailed manner prescribed by the act.

Under the lump sum method, the appropriation act authorizes certain amounts *in toto*, for certain purposes, such as salaries in a given bureau or division, and leaves to the executive the discretion to employ the number of workers, each with such qualifications, as may best suit the purposes of the division. If technical research assistants rather than clerks are wanted, there is freedom to make the change, within the aggregate amount available for salaries. This degree of freedom in the case of personnel is now possible, and more workable, by reason of the personnel and salary classification that has been worked out for the federal government. Thousands of different positions have been classified, each with its characteristic duties, qualifications and compensation scale. Consequently there is a considerable degree of uniformity as to compensation and qualifications for similar types of work in the different departments and a lump sum salary appropriation can be made with greater certainty that the administrative heads will apply it so as to get their work done. The states, in general, lack such basic revision of their personnel statutes.

The lump sum method is essential to proper executive control over the operation of the budget, as will be shown later, but it does not mean *carte blanche* for the executive. No appropriation act puts a large sum at his disposal, to be spent entirely at discretion.¹⁸ Certain major purposes and divisions of expenditures are always recognized, and the total authorized for any one of them is available within, but not without, that purpose. The sections or votes of the English budget and the chapters of the

¹⁸ The relief appropriation of \$4,800,000,000 voted by Congress in 1935 was an exception of unusual character. The act gave the President entire discretion in spending the money.

French budget, or any definitely established sub-heads under a vote or a chapter, constitute such fixed entities. The number of fixed headings, and the amounts authorized under them, will reflect the length to which the legislature is willing to go in permitting discretionary executive determination of the purposes of expenditure. Another definite rule in this connection is that funds voted for capital or current purposes, respectively, shall not be used for the other purpose. When the capital funds are obtained by borrowing, as so frequently occurs especially in local finance, the privilege of transfer from capital to current purposes would amount to borrowing to pay current expenses.

When should the budget be approved? The financial plan set out in the budget should be considered and approved, if possible, prior to the opening of the fiscal year to which it applies, yet as near to that date as the cumbersome processes of legislative action will permit. Since the bulk of the appropriations are made on a fiscal year basis, or on a longer budget period basis if the legislature meets only once in two or more years, the failure to vote appropriations before the next budget period begins is a serious matter. On the other hand, greater accuracy in determining both revenue yields and expenditure needs will be achieved if the legislation can be finally passed upon at a date reasonably close to the time when these calculations are to become effective.

A common source of faulty budget adjustment, especially in local finance, is the lack of synchronization between the budget year and the tax collection year. It frequently happens that cities and other local units will adopt their budgets and operate for six months or more under them before the first installment of the taxes levied for their support are due. Two results follow and both are bad. The first is that the administration must operate for several months on borrowed funds which are repaid when the taxes are finally collected. The cost of government is increased unnecessarily by the interest on the temporary loans, much of which could be saved by making adjustments in one place or the other. The second is that until the collections are actually made, it is not easy to forecast the revenue shrinkage due to delinquency and other causes, and there is a tendency to borrow and spend more than will be realized through the tax levy. A temporary or short-term debt results which must be included in following tax levies. If this is not done, the loans that cannot be repaid from tax collections must be refunded eventually, or they will wreck local credit.

If the legislature delays action until after the opening of the fiscal period for which appropriations under the new budget should have been made, it means administrative and financial paralysis, unless provided against. This is done either by permitting the appropriations of the former year to carry over, or by authorizing the executive to declare the new budget operative until such time as the legislature may have acted.

The correction of the budget. A sudden change in economic conditions, causing revenues to fall below estimates, or the emergence of unanticipated demands causing expenditures to rise above the authorized appropriations, may give rise to a situation requiring corrective action. To some extent the technique and the policy of controlling the execution of the budget, discussed below, provide safeguards against an unbalancing of this sort, although it may be produced by forces or conditions too powerful to be counteracted in this way. Two principal methods are available, under modern practices, for correcting the budget. One of these is the supplementary budget, the other is the deficiency bill. Properly used, these devices are helpful and necessary, but they are also capable of being used, or misused, in a degree which constitutes a fraud against the people.

The supplementary budget. This is an addition to or extension of the original budget. If it be prepared in correct budgetary form, it would consist of revised estimates of expenditures and revenues, either for old or new services. It would conform to the general principle of keeping expenditures and revenues in balance by proposing additional revenues to provide for any increase in the expenditures.

The deficiency bill. This is a bill to provide additional funds to cover a deficiency in an appropriation already made. The reason for the deficiency is that the department or agency is spending at a rate which will exhaust the funds originally provided before the end of the fiscal year. Its proper use would be limited to those cases in which some development which could not have been foreseen when the original appropriation was made had obligated the agency to increase its expenditures. In other words, the only proper justification for such a bill is a bona fide emergency.

The fraudulent use of deficiency bills by Congress has long been notorious. As long ago as 1870 an act was passed which forbade expenditures in excess of appropriations. It was never observed, nor were later acts of the same tenor. The budget and accounting act provides a regular procedure for transmission of deficiency estimates to Congress. As long as the practice endures, a great show of economy can be made by making severe reductions in the original appropriations, with the intent of providing additional funds, after the election, through deficiency bills. In consequence, the agencies are not impressed or deterred by the limitations apparently imposed by the initial appropriations, since they are reasonably assured of getting more money by asking for it. For example, from July 1, 1945 to April 8, 1946, 129 requests for deficiency appropriations were sent to Congress, involving a total of \$2.85 billions over and above the regular 1945 budget.¹⁴

¹⁴ The Citizens' National Committee, 'Round Washington, Supplement No. 88, April 15, 1946.

The Congressional Reorganization Act of 1946 forbids consideration by either House of an appropriation bill or an amendment thereto if it contains a provision reappropriating unexpended balances. An exception is made for appropriations for public works on which work has commenced. The same act also provided for a review of the permanent appropriations with a view to eliminating those for which a case no longer existed. A permanent appropriation is one which, once made, carries on from year to year without the need of new annual legislation.

Authorization to appropriate. A legislative device which has promoted the expansion of expenditures is the practice of enacting bills pertaining to all sorts of projects with a provision that the bill merely authorizes the appropriation of funds sufficient to carry out its purposes. In this way, it is possible to avoid immediate and direct consideration of the cost or of how and where the funds are to be obtained. It is much easier to approve a project, in principle, knowing that this approval is a powerful influence upon the appropriations committee itself. To take an extreme example, a bill could be passed which provided that the federal government would give a Ford automobile to every family with an income under \$2,000. Such a bill would be meaningless without some provision as to how the automobiles were to be bought. Following the procedure that has been developed, the bill would say: "there is hereby authorized to be appropriated an amount sufficient to carry out the purpose of this act."

This, of course, is not enough to compel the government to begin the purchase and distribution of automobiles. The above bill, and hundreds of others of like character, come to the attention of the committees of appropriations. The normal reaction of these committees would be to say "no." But they face the fact that the Congress has already voted to have these things done and have also voted an authorization of the appropriation. To refuse the appropriation under such circumstances would mean blocking the will of the majority, and this always means the possibility of losing votes at the next election. So why should there be a refusal to appropriate that which the Congress has already authorized to be appropriated?

The battle for any dubious enterprise is already more than half won when a bill can be passed carrying the mystic words: "there is hereby authorized to be appropriated."

The obvious remedy is to make and abide by a rule that no legislation involving expenditure shall be considered without first being referred to the joint committees on appropriations and revenue. If the subject of the bill is included in the budget of expenditures and revenues, the appropriation should be made. If it is outside the budgetary program as approved, an appropriation for the project should depend upon its cost and the availability of funds. The point here is that a decision as to how and where the money is to be found should not be prejudiced, in advance, by

a vote of the Congress which, in effect, indicates that the money is to be found, whether or no.

The significance of an unbalanced budget. A budget may be said to be in balance when the revenues and expenditures under it are equal. In theory it is unbalanced when either side exceeds the other, but the results and effects of a revenue surplus are quite different from those of a revenue deficit, as Mr. Micawber so neatly pointed out. An unbalanced budget, therefore, is understood to mean one in which expenditures exceed revenues. No one worries over the other kind of unbalance, unless it should be the taxpayer, but he is seldom considered.

For short periods revenue deficiencies are not serious. Additional funds may be obtained from old or new taxes, or expenditures may be adjusted. A prolonged deficiency of current revenues below expenditures must result in a collapse of governmental services or resort to heavy borrowing. Local and state governments can borrow only while the banks and the investors are willing to lend, but national governments, having control of the currency, may force the people to lend by issuing paper money. Back of every unbalanced national budget lurks the specter of currency inflation. This is the final resort, and it is virtually inevitable if the deficit policy is carried far enough. In view of the disastrous consequences of uncontrollable inflation, the concern with which national budgetary maladjustment is regarded is well founded.

The budgetary functions of the legislature. In concluding this discussion of the action upon the budget by the legislature, it is worth while to consider briefly some aspects of the general political theory involved.

Under any form of government in which the people have a share, there is always a certain conflict of interest between the people and the executive branch. That is, the inevitable tendency of the executive and administrative forces is toward autocracy. Even when the head of the state professes the utmost benevolence of policy and deliberately shapes everything toward promoting the welfare of the people, the tendency is there, and he gradually but steadily becomes autocratic in attitude unless held in restraint. It is essential that the executive head of any government have power and authority to get things done, but it is equally essential that he be continually subject to check and restraint, if the people are for very long to have a share in government.

The function of the legislature, acting as the people's chosen representatives, is to provide and assert this restraint. There must be a balance of power between the two branches, in the interest of democratic government.¹⁵ In exercising this restraint the budgetary function of the legisla-

¹⁵ In the United States a three-way distribution and balance of power is established, with the judiciary occupying the third corner of the triangle. This is probably a logical and practical necessity when the basic frame-work of government is a written constitution, but the experience of England shows that the essence of democracy is

ture is twofold. It embraces both approval and criticism. It approves an expenditure program through the enactment of appropriation bills, and it approves the levy of taxes to support the expenditures by enacting taxation measures. It should also criticise the operation of the program through a careful review of policies and performances. The viewpoint of this criticism is not destructive; it is not exercised for the purpose of hindering and hampering the executive in his administration of the public services. Its purpose is, or should be, that of verifying the claims and allegations made by the executive with respect to the quality of his administrative performance. The legislative attitude toward the executive involves, therefore, good will and confidence, expressed in voting appropriations and taxes, and critical detachment, expressed by demanding satisfactory evidence of rectitude and efficiency.

It is apparent that a "rubber stamp" legislature cannot properly fulfil both of these requirements. They are best met, as indicated by experience, when there is a strong two-party political system, and when the members of the dominant party of the moment are sufficiently aware of their legitimate function as legislators to respect the critical attitude of their opponents. In fact, the party in power should be as critical of the performance of the executive branch as the party in opposition, for executive failure or incompetence is a reflection on the party itself. Gag rule in its various manifestations may prevent disclosure for a time, but this kind of "murder," like the other kind, will come out eventually.

The spoils system has done more than anything else in the United States to prevent the development of competent two-party political administration, for it has placed the emphasis in political struggles on the building of party machines at the expense of the public, rather than on the competitive efficiency of performing public services. The people seldom have an opportunity to vote on clear-cut issues of policy and administrative efficiency in their performance. The chief accomplishment in an election is turning one set of rascals out to let another set in. Under these conditions, legislative criticism of the executive means loss of patronage, and any legislator who gets out of favor with the executive in this way might as well be at home. The probability is that he soon will be at home for good.

The following chapter will deal with the execution of the budget. In that connection more will be said concerning the critical function of the legislature and the manner in which it should be exercised.

possible without a formal constitution and a supreme court. These institutions could hardly be dispensed with in the United States until the administrators, the legislators, and the people have acquired a far more serious attitude toward the responsibilities of government than has thus far been displayed.

CHAPTER XXXVII

The Execution of the Budget

THE END AND purpose of the financial plan that is proposed by the executive and passed upon by the legislature is the provision of services by the government. Legislative action on appropriation and revenue bills constitute popular approval of the plan to provide and finance services, although there may be material differences between the final legislative program and that originally submitted by the executive.¹

It would probably be difficult for the average citizen to find much semblance of a budget in the mass of appropriation acts and other legislation, but these measures together contain the substance of the financial plan as adopted. It is naturally turned over to the executive branch for operation. This is not a surrender of the purse. The legislature is not competent to engage in actual administration, being too large and unwieldy. In any case, its proper function lies in another field, that of policy determination. By enacting appropriation and revenue measures it has set limits to the scope and the cost of administrative action under the plan adopted. When there is a completely rounded scheme of financial control in operation, the ultimate legislative procedure with respect to any financial plan, as will be seen later, involves steps designed to secure the accountability of the executive with respect to the power and responsibility conferred upon him by the plan.

NATURE OF EXECUTIVE RESPONSIBILITY FOR THE EXECUTION OF THE BUDGET

In a broad sense, the responsibility of the executive, in the application of the financial plan embraced within the budget, is the promotion of the general welfare. This is, of course, the purpose and objective of all government. Presumably the legislature also had this general end in view in making its own contributions to the program. However correct in the abstract, such a vague, general statement provides no definite clue to the tests that must be applied in specific cases of executive performance in collecting revenues and making expenditures. At least three fairly definite

¹ A. E. Buck, *The Budget in Governments of Today*, p. 216, suggests that a statement be prepared showing the effects of legislative action on the executive budget.

tests or requirements must be met. There are: (1) accuracy in complying with the terms established by the legislature in the laws which authorized the budget plan; (2) efficiency in the use of funds to provide services; and (3) reasonable regard for economy in the operations undertaken. The essence of fiscal control is found in the practice and procedure by which these tests are met.

The test of accuracy. In the sense employed here, accuracy involves the practices and procedures of accounting and auditing. There must be a correct record, in proper books of account, of all the transactions involving receipts and payments. But there is more to the matter than merely correct bookkeeping entries, important as these are. Before any transaction which involves the government either as creditor or debtor is settled, there must be verification of the legal basis. The legality of the transaction must be decided according to the law which authorized it. All rules of governmental financial procedure, whether set out in constitutions or in some other way, provide that the government shall not pay money out of the treasury except in accordance with law. This means that the payment must be authorized by an appropriation, that the claim in question represents a payment which may properly be made under the appropriation, and finally, that a sufficient unused and unencumbered balance of the amount appropriated remains to cover the claim.

The tests of efficiency and economy. *Efficiency* and *economy* are vague words, use of which together verges on tautology. Without some approach to the technique of expenditure control that is outlined in Chapter VII the administrator can never be certain about the degree of efficiency achieved by his organization. The comforting, but at the same time disquieting thing is that his critic can never be certain of it either. Lacking the fundamental and thoroughgoing basis required for genuine efficiency, the two measures now available which look to that end are central purchasing and control through allotments.

Central purchasing. The buying of supplies for different branches or departments of the public service by a single agency is centralized purchasing. Its main purpose is the cash saving that can be realized through quantity purchases and lower overhead. The alternative is to permit each separate spending agency to purchase its own supplies and materials as they are needed. The wastefulness of the decentralized purchase policy is obvious. Each unit buys in relatively small quantities, and hence pays higher prices. Each may specify a different brand or quality, and may order some unusual article at a higher price without due regard to its relative quality in use. Unless each unit is qualified to inspect all deliveries, there can be no assurance that the goods received are of the quality ordered and paid for. In each separate buying unit, there must be employees who do the ordering, others who keep the records, look after the stores, check deliveries and withdrawals, and so on. Decentralized pur-

chasing means greater overhead, higher unit prices, less certainty as to quality, and hence it must be regarded, for large units, as wasteful management.

More than this, the several governmental departments or units may be bidding against each other, as the army and navy did during the first World War, thereby advancing the price excessively, or they may be paying different prices for the same article. Forbes reports that a survey in the City of Toronto revealed variations of 50 to 100 per cent in the prices paid by different departments for the same article. In addition to the difficulty of securing a uniform policy, there is the further disadvantage that out of many separate purchasing agents, some will be found who lack proper standards of integrity. Closer control of the public funds is possible when all of these operations are centralized.

The management task involved is relatively simple, by comparison with that confronting some purchasing departments of private concerns. The government's requirements are not, as a rule, widely varied and complicated. For the most part the supplies needed are available in the open market. Delivery is seldom urgent, in view of the languid tempo of government operations. Yet there is need to control and standardize specifications, in order to assure prudent use of public funds on a fair value basis. There is also need of careful test and inspection of deliveries for the same reason.

The proper place for the organization in charge of purchases, in the case of the state and local governments is in the department of finance. The routine of accounting and auditing is more readily developed and supervised there, and the emphasis upon standards that should characterize other aspects of the department's supervisory activity will promote better results in this direction in the purchasing bureau.

Since the operation of such a bureau involves some costs, the resultant savings must be balanced against these costs, and in consequence this particular feature of financial administration is not available or advisable in the case of small units, although these may secure certain advantages of centralized buying by arranging to obtain various types of standard material, such as cement or sewer pipes, from the purchasing department of a nearby larger unit which is able to buy in quantity more cheaply.

Space cannot be given here to a lengthy discussion of the technical details of the subject, for which reference must be made to the special treatises.² Some of the advantages and disadvantages may be briefly indicated.

The chief advantage is the saving that is achieved through lower unit costs and possibly better discount terms, when larger quantities are

² Cf. Russell Forbes, *Governmental Purchasing* (1929), and A. G. Thomas, *The Principles of Government Purchasing* (1919).

bought. Direct savings may also result from the lessened expense of buying, maintaining stocks of supplies, and the routine of stores administration, when this function is centralized for all departments. Indirect savings, which may result in actual cash advantages of the service departments, are realized through the improvement of uniform standards and specifications, a better balance of supplies and more prompt delivery service, and a more effective accounting control. There is also an advantage to vendors in having to deal with only one office.

The objections center chiefly about the unsuitability of articles bought for certain uses. This can be overcome by more careful attention to specifications, and closer inspection of deliveries with a view to testing compliance with the standards set. Complaint as to deliveries may arise, but any purchasing system should be flexible enough to permit emergency independent purchase, under proper control. For the rest, proper programming of departmental activities should promote the satisfactory coordination of supplies with this program, unless the delay be due to industrial or transport congestion, in which case independent purchasing would hardly avail.

Central purchasing is quite generally found in the larger cities, and it occurs in about three-fourths of the states. The region in which it is most generally lacking is the southeastern section, Tennessee being the only southern state east of the Mississippi which has introduced it. The practices and the type of organization vary. In most of the states exemption is allowed for emergencies and for perishable food-stuffs bought by the using institution. Highway departments have been able to keep out of the system in some states, although the bulk of the materials used could be bought advantageously by a central bureau. Forbes says that the ability of state agencies to obtain this exemption is a tribute to their political influence rather than a recognition that their requirements could not be met acceptably in this way.³

In about one third of the states the purchasing bureau is established under a finance department. Too large a proportion of the states are still using a separate purchasing board instead of integrating this activity with the other aspects of good financial management. A procurement division in the federal treasury performs central purchasing services with respect to some classes of public construction such as post office buildings and hospitals, and also with respect to a certain proportion of the general supplies used by the various departments. During the second World War this division also bought large quantities of matériel under the Lend-Lease program.

Allotments. The use of allotments involves a theory of the nature of the legislative appropriation which has long been held in England, but which is not everywhere recognized in this country. It is that the appro-

³ *Op. cit.*, p. 40.

priation is only an authorization to spend, and not a definite grant of funds to the spending agency. Under the latter conception of the meaning and intent of an appropriation act, the executive has comparatively little control over the manner in which the several spending agencies manage their funds, except by the relatively harsh method of suspension or removal.

When the appropriation is regarded as merely an authorization to spend, the way is opened for a more definite control over the actual expenditure by the executive. Under the English procedure, the appropriation is a grant to the Crown. The first step is, therefore, a royal order, addressed to the Treasury, requesting it to set the amount in a particular appropriation at the disposal of the Treasury. This sounds tautological. It means that the Treasury is to arrange transfer from the exchequer account to its own account. The transfer is arranged through a treasury requisition to the Comptroller-General, authorizing him to grant the credit against the Exchequer account at the Bank of England. His duty at this point is to make certain that the requisition is in accord with an act or acts of Parliament. When the money is in the treasury account and under its control, daily transfers are made to the Paymaster General in amounts sufficient for him to pay the bills incurred by the departments. The Treasury is not required to make the entire amount available. This is a matter to be determined by policy considerations. If an administration were to aim at economy, the spending could be kept down; but the fact that the administration in power has already determined the volume of spending through its budget and the appropriations would diminish the incentive to practice at one stage an economy which would better have been established in the original planning.

The control over the use of funds does not assure, either, that the several departments will observe prudence in their application of the money. Hilton Young observes that the British system is well designed to prevent the government from getting money not authorized by Parliament, but it is of no value in enforcing economy and preventing waste.⁴ It prevents money from being used outside the law, in a way in which there is today little temptation to use it. It does not prevent waste within the law, and a preventive of this sort is the most urgent need of the state.

The allotment system is used by a few states and by some of the cities. Ordinarily they are made at quarterly intervals. As in England, the several service agencies submit quarterly work or service programs to the department of finance (or to such other fiscal control agency as may be constituted for the purpose) with a request for the sum considered to be required. These requests are reviewed and notice of the action thereon is given to the agency concerned and to the treasurer. Then, and

⁴ E. Hilton Young, *The System of National Finance*, pp. 103-105.

not until then, the treasurer opens an account with each disbursing agency, in the amount of the allotment. As further programs are approved and allotments made, the treasurer extends additional credits, and the spending agencies incur bills which are pre-audited and ordered paid from these credits.

There are some highly important advantages in this procedure. The first is that it provides definite, clean-cut executive control over the performance of services and the expenditure of money for them. It also fixes the responsibility for administrative operation definitely on him. At this point it is in sharp contrast to the policy of direct appropriation to the spending agencies over which the executive has no control, and for which he has, therefore, no great direct responsibility.

The second advantage flows from the first. This control may be exercised, when necessary, to maintain budgetary balance. If revenues are declining, the allotment schedule may be revised downward. The Utah budget law requires the treasurer to notify the governor of any marked shortage of revenues, whereupon the governor is required to modify allotments to the end of averting a deficit.

A third advantage is possible when central purchasing is coordinated with fiscal control, for the savings achieved through central purchasing can then be made effective by controlling allotments to conform to these gains. Under the old system the result of greater economy in purchasing would have been that the several departments would have had more to spend on other things. In passing the appropriation acts, more than a year before the actual spending is to be done, the legislature cannot anticipate price changes and thus establish maximum amounts that would be reasonable. If there should be such a sudden and marked upward price movement that the appropriation proves inadequate, even after the savings of central purchasing are allowed for, the executive still has the opportunity of submitting a supplementary budget, or deficiency estimates, and asking the legislature for additional authorizations, together with revenue changes to provide the funds.

Fiscal control thus makes possible the correction of one group of errors that may have entered the budget calculations of both the executive and the legislature. These are the errors that led to the appropriation of more than was actually needed. The inability to foresee not only future price changes, but the course of other future events accurately often results in undue allowances for their possible effects. As the fiscal year advances, fiscal control permits corresponding corrective adjustment, a proceeding obviously not possible except with difficulty under the system of fixed appropriations.

Finally, it is a device by which the executive can exert some pressure on the administrative forces in the direction of greater efficiency. Within limits and with an administrative organization motivated by a proper

spirit, this pressure may have salutary effects, just as the fixed appropriation subject to no change whatever befalls, may have a demoralizing effect.

The policy of mandatory appropriations is, of course, inconsistent with the flexibility aimed at under a proper system of fiscal control. The states have been guilty of overloading their local units with mandatory requirements, often with no regard to the limitations of the local revenue system. In one respect, namely the debt service, no executive authority can expect freedom to exercise discretion regarding the amount or the time of payment. But mandatory legislation has gone far beyond the debt service. The states have fixed local salaries, they have sometimes created local offices with definite salaries, and they have imposed many other obligations without admitting the exercise of local discretion in determining the cost of discharging them. Under such circumstances there can be no effective executive control of local budgets.

Mandatory appropriations outside of the debt service are much less common in state and federal, than in local affairs. The practice should be entirely abandoned in the interest of achieving greater flexibility of budgetary operations everywhere.

An apportionment procedure is employed by the federal budget bureau, but its purpose is primarily that of assuring observance of a program under which the departments are enabled to operate through the year within their respective appropriations. In federal legislative theory the appropriation is a grant to the spending agency. The President has no direct power to withhold any part of this grant, but his wish or suggestion can be indirectly enforced through his power to remove a recalcitrant department or bureau head. The apportionments, which are agreed upon in conference between the budget bureau and the respective departments, relate to each appropriation as a whole and are ordinarily a distribution of the total into twelve monthly installments. These are equal amounts unless, by agreement, a different basis of apportionment over the year is established. Each department thereafter allots the monthly quota among the various bureaus and other sections in the department.

In order to make payments under appropriations, each spending agency requests funds on a standard requisition form. These requisitions go to the Comptroller General for approval, then to the Treasury, where steps are taken to transfer funds to the account of the disbursing officer for the agency named in the requisition. Each such officer then proceeds to pay the bills for his agency, on the basis of the obligations incurred, as certified to him by the administrative head of the agency.⁵

The correction of internal budget errors. In one respect the developments of the fiscal year may disclose errors of judgment that may require

⁵ For a more complete account, cf. D. Selko, *The Federal Financial System*, Washington, 1940, Chs. IX, XXI.

correction which can be made without affecting the overall financial situation. Such an error is the failure to make the proper apportionment among the services. Hence, in actual operation one agency may exhaust the whole of its appropriation before the fiscal year ends, even though it be operating under strict control, while another may be certain of concluding the year with a comfortable surplus.

One method of correcting this situation is the deficiency estimate, or even the supplementary budget already described. Yet it seems illogical to ask the legislature to provide more tax revenue when there will be, altogether, a surplus of funds.

Transfer. Another corrective device is the transfer of funds from one appropriation account to another. The problem is how far to go in permitting this to be done. On the surface there is no problem, but it is clear that complete freedom of transfer would mean that the executive could entirely disregard the limits on expenditure for various purposes set by the legislature in its appropriation acts. Complete freedom of this sort is not lightly to be given. On the contrary, it must be kept within rather close limits, else the legislature will have surrendered to the executive the right to order payments that have not been authorized by law.

In practice, therefore, the transfer is available only for shifts from one agency to another when the two are so closely affiliated that both are essentially parts of the same purpose. In England, transfers are permitted only among the sub-heads of a "vote," except for the army and navy votes, but these purposes together constitute what may be regarded as a national defense vote, hence the exception is not wholly illogical. Congress permits but little freedom of transfer, preferring to authorize deficiency appropriations, a policy which has the merit of retaining legislative control of maximum authorizations for any service. The states have followed the inconsistent course of relatively rigid appropriation acts, with comparative freedom to make transfers.

Emergency fund. Another device for making internal adjustments is the contingency or emergency fund, which is an unallocated appropriation to the executive to be used in supplementing deficiencies in particular services as needed. The practice is useful but the amount thus set aside should be small, lest it will encourage carelessness in the original budget and appropriation plan.

BUDGETARY REVIEW AFTER EXECUTION

According to the procedure here outlined, the executive has had a comparatively free hand in directing and controlling the application of the plan for providing governmental services as set up in the budget and its supporting legislation. He has been subject to the limitations on overall expenditure, and to the application of funds to the different services,

established by the appropriation and revenue legislation, except as minor transfers and adjustments have been permitted. The final step should be a review of his operations and their results. This review should be two-fold. It should embrace an audit, and a survey by the legislature.

The audit. The auditor's task is primarily verification. This is first of all an examination of the actual transactions, as recorded in the books of account and supported by claims, vouchers, payrolls, statements, and other documentary evidence in the files explanatory of the payments made and the funds received by the treasury. The examination should extend also to the property accounts, and to the record pertaining to the public debt, the sinking funds, the trust and other special funds. In short, it should be a comprehensive survey and review of the entire field of financial and business operations of the government.

Not only the correctness of the accounting records, as a matter of accounting, but also their correctness as a matter of conformity with the legislation which authorized the various transactions, must be considered. The examination of records and transactions ordinarily proceeds currently. The steps in this examination are the following: (1) a verification by the administrative head of the spending agency. This official issues a voucher, attaches it to such documents as may exist whereby the validity of the claim and the correctness of its amount may be attested, and sends it to the appropriate disbursing officer. (2) The disbursing officer examines the voucher and its supporting documents, and if he is satisfied as to the propriety of paying it, a check is issued. At the state and municipal level the treasurer acts as disbursing officer for all departments. At the federal level there are numerous disbursing officers, in Washington and at different field points. (3) The accounts of disbursing officers are periodically examined and settled.

It appears, thus, that there are at least three stages in the examination procedure, all designed to promote conformity with the provision in federal and state constitutions which requires that no money shall be paid out of the treasury except in accordance with an appropriation made by law. The first is the administrative examination which is made by an administrative officer, that is, by one in charge of the unit which performs the work and thus incurs the expenditure. The second stage involves an accountable officer, who will be the state or local treasurer, or the federal disbursing officer. In the federal parlance an accountable officer is one who is required by law to make periodic settlement of his accounts with the General Accounting Office. The third stage is the audit proper, which is the independent examination made by the auditing authority.

In the case of cities and other local units, the final review may be made by a state department in charge of local accounts or by private accounting firms certified for the purpose by a state agency. At the state level there is always a department of audit. The extent to which the audit of state

and local government accounts is kept current varies, though there is a general tendency to advance toward the goal of a completely current examination. All federal accountable officers submit their accounts for final examination and settlement on a monthly basis.

In these periodic reviews it is the function and duty of the General Accounting Office to certify the account as correct, or to suspend it if questionable payments are found to have been made. If an account is suspended because of some irregularity, the disbursing officer or his surety (a bonding company) is supposed to make good a deficiency arising from any payment found to be unlawful, before the account is settled.

Two devices have been introduced with a view to expediting payment while providing at the same time all necessary safeguards. One is direct settlement, a practice employed with respect to some types of payment from the beginning of the federal government. It means that the administrative officer sends the voucher and its supporting documents directly to the audit authority for certification as to legality and accuracy. The other is the advance decision, which is made by the General Accounting Office, upon request of either an administrative officer or a disbursing officer, prior to making a payment. This office is subsequently bound by its ruling in settlement of the disbursing officer's account. Another term for the advance decision is *pre-audit*, which also means an audit of current vouchers before payment is made upon them.

The recovery of funds found to have been improperly paid out is not easy, despite the fact that the disbursing officer is deemed to be primarily responsible. A considerable period may elapse between the date of payment and the time when the accountable officer in question can submit his explanation, particularly if he is stationed at some remote point. Because of this interval the person in question may leave the government service, or he may die, a fact which involves dealing with his estate. There is a lack of uniform methods and standards for setting bonds, and a division of responsibility between administrative officers and disbursing officers which may cause the burden to fall unjustly on the latter. Finally, action for recovery must be taken by the Department of Justice, which may take a different view of the facts. Selko suggests, as remedial measures, the fixing of greater responsibility upon administrative officers, and denying the Attorney General all authority to pass on the legality of expenditures.⁶

It should be noted that the collectors of revenue are also required to submit their accounts regularly for examination and settlement. Budgetary control evidently includes the steps necessary to assure that all resources due to the government shall be properly accounted for, just as it includes the steps involved in making certain that no money shall be paid out unlawfully.

⁶ Selko, *op. cit.*, p. 380.

The auditor's function is broader, however, than verification of accountability in the strict accounting and legal sense. He has some responsibility to examine and judge the executive interpretation and application of the policy set out in the financial plan authorized by the legislature. The purpose of this examination is more than the detection of error or fraud, significant as this service may be on occasion. Its broader purpose is to provide a means of informing the people, and their chosen representatives, the legislature, concerning the administrative standards and the policy viewpoint of their administrators. Shirras sums this up by saying that "The ideal auditor should, in fact, be one who asks every question that may be expected from an intelligent taxpayer bent on getting the best value for his money."⁷ Public auditing does not uniformly rise to this level, and when it does, its results are seldom carried to the people, or even to the legislature, in a form suitable for general consumption. In consequence, public audit reports may give assurance as to the accounting and legal fidelity of public officials, but they have generally failed to serve as a basis of popular judgment on policy issues. They do not actually tell the taxpayers what they should know about the manner in which their money has been spent.

The legislative review. The idea of legislative review and critical consideration of the manner in which the executive has fulfilled its responsibilities in its operation of the budget plan is new in this country, although it has long been an established procedure of the House of Commons. There this review is directed by a public accounts committee, first instituted by Gladstone in 1861. The committee usually numbers fifteen and its chairman is always of the opposition party. An effort is made to include the members of any party who may be distinguished by a knowledge of public finance, and Hilton Young says of their service: "Many gallant stands have been made at that Board for order, regularity and economy in the methods of public finance."⁸ As the foregoing may indicate, the committee's task is primarily a review of policy, and incidentally that of verification, for it relies upon the reports of the auditor and comptroller general with respect to the latter. Thus the auditor and the legislative committee supplement each other, each stressing one major aspect of the problem but also considering the other.

Certain features of the English procedure are of particular interest. The committee meets in private. The members deliberately withdraw themselves from exhibition before the camera and the notebook of the reporter, a reticence truly shocking to the sensibilities of the average American politician. Again, the object of the inquiry is the improvement of the public business, and not primarily the manufacture of campaign ammunition, although, since the committee reports to the House, its

⁷ G. F. Shirras, *The Science of Public Finance*, p. 609.

⁸ E. Hilton Young, *op. cit.*, pp. 129, 130.

findings are available for political purposes if any opposition member desires to use them.

Finally, the Treasury, which is represented on the committee, is usually in accord with the findings, since their purpose is genuine improvement in the public administration, and the members of the majority party are quite as keenly interested in correcting their mistakes as the members of the opposition may be in pointing them out. There is no thin-skinned inability to take criticism and no intolerance of the critic; neither is there any hole-and-corner covering up of unpleasant truths. The Treasury takes up the committee's findings with the departments concerned, and in Young's words: ⁹

If the committee has censured something, the Treasury communicates the censure, adds its own, and tells the department that it must not happen again. It is common indeed to find an opinion expressed with judicial mildness by the Committee enforced with far stronger language by the Treasury in communicating it to the department. Where the Committee has roared as mildly as a sucking dove, the Treasury roars like a Libyan lion.

Defects of budgetary review procedure in the United States. There is, of course, no legislative review of the results of the budget plan in this country, of the sort now made by the public accounts committee in England. Congress does have certain committees analogous to the English committee,¹⁰ but they have ordinarily limited their activities to the investigation of specific and individual instances of mismanagement and maladministration, and their interest in such matters is likely to be slight unless the House or Senate be controlled by one party and the administrative branch by the other. There is no coördination of their activities and no interest in the broader aspects of the budgetary problem.

A. E. Buck suggests¹¹ the elimination of these committees and the creation of a joint congressional committee on public accounts. The chairman and a majority of the members should be from the party in opposition to the President. It should rank as one of the most important committees of Congress, and its members should be chosen from the ablest members of both houses. Its primary subject of consideration should be the critical reports of the auditor general, and by requiring the attendance of the Secretary of the Treasury, the President would be kept in touch with its findings. He adds:

It would be the duty of the Committee to hold hearings on the findings of the Auditor General, summoning before it for examination departmental heads, administrative boards, bureau chiefs, accounting and disbursing officers, and other executive and administrative officials. At the conclusion of these hearings the Committee would report to Congress, giving its criticisms on financial

⁹ Young, *op. cit.*, pp. 130, 131.

¹⁰ The House and Senate each have a committee on expenditures and the House has, in addition, a committee on accounts.

¹¹ A. E. Buck, *The Budget in Governments of Today*, pp. 295 ff.

methods and performances and making any suggestions it deemed appropriate either for legislative action or executive guidance.

FEDERAL GENERAL ADMINISTRATION

The most fundamental question that arises, in considering the administrative needs of the federal government, relates not simply to financial administration, but to general administration, within which financial administration would be an important, but not the sole constituent. Willoughby has suggested a bureau of general administration.¹²

The model which both Willoughby and those who have thought in terms of financial rather than general administration have had in mind is the English Treasury. This organization is not a treasury department at all in the ordinary sense. It collects no taxes, handles no funds, supervises no accounts, has nothing to do directly with the public debt. The name is an historical accident. It is, in fact, the best known example of an organ of general administration. Willoughby's account of what he learned of its functions at first hand is clarifying: ¹³

... upon it fell the duty and responsibility for the final form of organization the several departments of the government should have, what personnel was needed, what compensation should be paid, what new undertakings should be authorized, what changes should be made in the employment of funds as provisionally allotted by Parliament, what the works program of the government should be, etc.; ... in discharging this function it was its duty to keep itself thoroughly informed regarding the condition and needs of the several services and use its utmost endeavor to see that the government operations were conducted with the maximum of efficiency and economy; ... in a word, the Treasury was the one authority to which Parliament and the public looked to see that public affairs were administered in an economical and efficient manner.

Considering the scope and complexity of the federal administrative organization, there can be no hesitation in saying that the great need in Washington is for such an organ of general administration. The President needs it to act as his agent in controlling and coordinating the several service departments and bureaus. Obviously this is a much broader subject than financial administration, although, as stated earlier, finance pervades all that government does.

Assuming that good government requires the existence of facilities for general oversight akin to those provided by the British Treasury, it would appear that the best opportunity of moving in this direction would be by an expansion of the functions of the Budget Bureau. Selko suggests that the bureau might undertake to gather "periodic or occasional

¹² W. F. Willoughby, *Principles of Public Administration*, Ch. IV.

¹³ W. F. Willoughby, W. W. Willoughby, and S. M. Lindsay, *The System of Financial Administration in Great Britain* (1929), pp. 178, 179.

information relating to the methods of conducting government activities." He points out that this type of information can be obtained only by investigation and first-hand observation. Its acquisition and interpretation would require a well-trained staff which would be free to make studies both in Washington and in the field, choosing such subjects as would best suit the President's needs.

But the mere collection of more information would not suffice. There should be a closer coordination of effort. On this point Selko writes as follows: ¹⁴

The Budget Bureau's activities with respect to co-ordination could with good reason be extended. Co-ordination can best be performed through a central staff agency equipped with the necessary authority and information. As the Bureau of the Budget is directly attached to the Executive Office it is the logical agency to perform this function. Not only should it be a center for the maintenance of information on new activities, but it should take the initiative in bringing about the elimination of costly administrative practices. Where duplication cannot be prevented by reorganization because reorganization for certain other reasons is not feasible, the bureau should attempt to establish a working relationship for co-operation between the agencies involved.

¹⁴ *Op. cit.*, p. 175.

CHAPTER XXXVIII¹

The Case for a Balanced Budget

IN ITS REPORT on a post-war tax program, the Committee on Postwar Tax Policy made the following recommendation on budget policy:²

We recommend the balanced budget as the normal practice in the belief that such a policy, being indicative of fiscal stability, will be more beneficial for the private economy and more conducive to the long-run stimulus of private effort than a policy of deficits. Our concern here is with the maintenance of production, employment and consumption through private enterprise. It is possible to create purchasing power through income payments made from government deficits, but there is no experience with this method of bolstering the economy that would demonstrate it to have the energizing quality so essential to sustained prosperity.

This position was not argued at length in the report. The language just quoted states a credo, an article of faith based upon the lessons of experience and upon logical deduction. The foregoing recommendation has been challenged by various sympathetic critics who have expressed doubt that the economic machine will work in all circumstances under such a fiscal program. It is proposed to undertake here some elaboration of the case for a balanced budget, but the views expressed are those of the writer and are not intended as a judgment of the Committee.

The problem must be dealt with by deduction, since no inductive proof can be provided except by the action of Congress in holding to a balanced budget policy as the normal fiscal procedure over a period of years. There is, to be sure, the experience of England after 1929, which suggests that budgetary balance is attainable through a depression and that such a policy is not a hindrance to prompt recovery.³ The argument from this sort of analogy encounters the objection that different conditions in the two countries invalidate the comparison.

Many factors are involved in the successful operation of the economic machine, and the responsibility for this outcome rests broadly on all—

¹ The material in this chapter has already appeared in *The Tax Review*, December, 1945, January and February, 1946. Published by The Tax Foundation, New York. By permission.

² The Committee on Postwar Tax Policy, *A Tax Program for a Solvent America*, New York, 1945, p. 22.

³ *Ibid.*, pp. 31-36.

managers, workers, investors, and government. We are concerned here with the particular matter of budget balance as an aspect of fiscal policy, and specifically with the question whether the maintenance of a balance will be favorable or adverse to the beneficial functioning of the economy.

The principal implication of the challenge referred to is that the economic machine, by which is meant the private enterprise system plus the ordinary operations and activities of government, may not be capable of working well enough under a balanced budget to satisfy present-day standards. In terms of current thinking, "working well" means providing an adequate volume of employment. It is sometimes said that when attention is fixed solely, or primarily, upon the matter of budget balance, achievement of that end may, and in some circumstances is likely to, result in a considerable amount of unemployment.

It would be well to pause here to define *employment*. This term is usually taken to mean being at work for a private employer, or for one's self, or for the government in the conduct of its ordinary, normal services and activities. The Bureau of the Census has followed this definition. In the 1940 census of the population the following occurs: ⁴

The total number of unemployed, as usually defined, includes (1) persons seeking work and without any form of public or private employment, and (2) those on public emergency work programs established to provide jobs for the unemployed.

It is a familiar fact that the amount of employment varies, both seasonally and cyclically. The core of the issue to be discussed is whether or not there is a demonstrable causal connection between budget policy and these variations in employment. The cyclical variations are the more important, quantitatively, and thus we encounter the questions—would a balanced budget cause an economic depression, and would an unbalanced budget prevent a depression? This, it must be emphasized, is a very different matter from the question of what should be done by government if and when unemployment should appear. We may grant at once that government cannot provide as much income for the unemployed through doles, made work, or useful public works, under a balanced budget as under an unbalanced one. This does not prejudice the argument that it is possible to do enough for the relief of unemployment under a balanced budget.

The current proposals for government action to assure so-called full employment really deal with the secondary or symptomatic, rather than the primary, aspect of the main issue. That is, they consist of the specific arrangements to be made for the support of those who happen to be unemployed. They do not touch at all the primary problem of the cause

⁴ United States Census Bureau, *Sixteenth Census of the United States: 1940, Population*, Vol. III, pp. 3, 4.

and prevention of the unemployment that is to be relieved, when it occurs, by government action.

If we begin with the first of the questions posed above, namely, would the maintenance of a balanced budget be a cause contributory to the onset of an economic depression, the answer must obviously be in the negative. The period of depression will have been preceded by one of boom and prosperity. A point on which all tax planners are in agreement is that the budget should be in balance under highly prosperous conditions. At such a time there would be high level employment, ample production, and a substantial flow of income to the people. In this kind of situation there would be no need of the inflation that is produced by budget deficits. Even by the advocates of spending, the absence of deficits is regarded as a desirable condition during a boom.

In the course of the long-range cyclical variations of economic activity, the boom gives way to depression. Many explanations have been advanced to show why this transition occurs. They vary widely and are highly selective in the range of factors and influences to which the depression after a boom is attributed. Professor Alvin Hansen has classified these numerous, diverse theories of the economic cycle as (1) technological developments, innovations, exploitation of new resources, and the opening of new territory, (2) war, or (3) gold and price movements.⁵

The writers who have advanced one variant or another of these theories have sought to explain, in terms of the appropriate phenomena selected, how there is provided, first, a stimulus to the economy which leads to a boom, and second, a transition to a depression as the effect of the particular stimulus chosen for emphasis wears off. So far as the present discussion is concerned, the specific theory by which the economic cycle is explained is not of great importance, since all of these theories agree that a depression will follow a boom. It is likely that no single explanation of the economic cycle is wholly adequate at all times and under all circumstances. On the other hand, there is greater likelihood that various factors are contributing, in one combination or another, to the wave-like movement of economic activity that is identified as the economic cycle.

The main thread of our argument is the connection, if any, between the balanced budget as a fiscal policy of government and the operation of the factors which bring about the transition from boom to depression. It is characteristic of cycle theory that a certain inevitableness is postulated, which would imply the operation of forces and trends too powerful to be entirely checked or halted. In any event, the prevention of depression necessarily involves the prevention of the preceding boom. Only in a completely static economy would this be possible, and the economic stagnation that would thereby be produced would condemn any attempt on the part of government or individuals to eliminate the dynamic

⁵ Alvin Hansen, *Fiscal Policies and Business Cycles* (1941), pp. 32 ff.

impulses which periodically advance the standard of living by great steps.

If the transition from boom to depression is really inevitable, then no sort of fiscal manipulation on the part of government would be effective in wholly preventing it. Assuming that no steps had been taken to throttle the preceding boom, the only hope of averting the ensuing depression would be to prevent the boom from fading out. This would be a delaying action in the form of a program of inflation during the boom on a scale that would carry it on beyond the point at which, in Hansen's words, it would have "died a natural death." Measures of this extraordinary sort would sustain the illusion of prosperity for a time, but they would lead eventually to a collapse that would be the more severe because of the manner of its deferment. The excesses of a depression tend to counterbalance the excesses of the preceding boom.

If the economy is destined to move from a boom into a depression, will the fact that the federal budget is in balance during this transition cause the movement to be more abrupt and the consequences to be more severe? A parallel question is: Will the maintenance of a balanced budget during the depression prolong it and hinder the operation of the forces that eventually work for recovery?

The first point to be considered here is the level of the budget. The taxes required to cover the expenditures are always burdensome. Heavy taxes are more burdensome than light or moderate taxes. In view of this principle, a large budget would be a definitely greater handicap than a moderate budget. This was recognized by the Committee on Postwar Tax Policy when it pointed out that the maintenance of budget balance would be more difficult, even in the prosperous years, if it were to include liberal provision for the optional and extraneous services which it is always easier to grant than to refuse.⁶ The argument is even more applicable in depression periods, and leads to the conclusion that there should be, at all times, prudent expenditure control in order to avoid the excessive strain that is certain to be involved in the lean years.

The next point to consider is the basic economic character of the process of keeping the budget in balance. This process is essentially one of transferring income or purchasing power from the citizens to the government with little or no net effect upon the aggregate. The government spending occurs with sufficient regularity and promptness to bring into the market, from government sources, the purchasing power which the citizens surrender in taxes. Thus, the maintenance of budget balance during the onset of depression or throughout the depression does not diminish the total of purchasing power that is available. The shift from boom to depression, in itself, means a decline of total income and purchasing power. Keeping the budget in balance does not accelerate this decline since the spending will equal the taxes.

⁶ *Op. cit.*, pp. 22, 23.

Nevertheless, the taxes required for budgetary purposes would absorb a larger share of income in a depression, because of the decline of total income and the inability of government to reduce expenditures proportionately to the decrease of income, even with vigorous expenditure control. But the government payments would also provide a relatively larger share of total income, thus avoiding a net inroad on purchasing power by reason of taxes. It becomes necessary, however, to consider the effect of the required taxation upon the economic incentives, for these are not wholly eliminated in a depression, although their potency may be temporarily impaired. The effects of taxation may go beyond the mechanical aspect that is involved in the transfer of purchasing power, if the burden becomes such as to impair the real standard of living. In such a case the encroachment upon incentives may become serious.

The double-barreled nature of the national income concept comes to the rescue here. When this concept is expressed in dollar amounts the total involves both the volume of production and the price level. In a depression both factors enter into the decline of total national income. The relative contribution of each to the aggregate decline may vary at different times and in any case is not readily measurable. Insofar as the price decline may be significant, the real standard of living is somewhat protected, despite such increase of taxation as may be necessary.

The character of the taxation imposed during a depression is also significant, both from the standpoint of ability to preserve budget balance and of the effects of taxation upon incentives. The Committee on Postwar Tax Policy emphasized the importance of diversity in the tax system in order to sustain the revenues under varying economic conditions.⁷ To this end it advocated retention of a substantial volume of excise taxes because of their demonstrated productivity under those economic conditions in which the income taxes become relatively impotent as a revenue source.

The productivity of even the excise taxes will depend in considerable degree upon the diffusion of income among the population during a depression. Here we must enter upon an area of lively dispute, but it is one of such significance that the heat of argument must not dissuade us from dealing with it. We refer to the question of wage policy. It is accepted in some quarters that there must be no reduction of wage rates in a depression, without regard to the arguments advanced and the policies pursued for the purpose of securing increases of wage rates during the boom period. The most elementary consideration of the course of events as the depression progresses will reveal that a characteristic phenomenon is a decline of prices and of profits. The rigidity of wage rates under these circumstances is a primary factor in causing unemployment because of the constant struggle of employers to hold costs within

⁷ *Op. cit.*, Ch. 2.

the shrinking boundary of falling prices. The restriction of employment that is produced by the maintenance of wage rates becomes significant because of its operation to confine the income generated by the economic system during a depression to a number of income recipients considerably less than the entire labor force. Remember that we are now discussing the productivity of the excise taxes, a result which depends upon widespread or so-called mass consumption of the commodities subjected to excise taxation. If, as an extreme assumption, only three-quarters of the labor force are in receipt of wage income, the volume of purchases involving excise tax will be correspondingly reduced. It is the sheer number of purchasers that makes for the productivity of excise taxes.

The critics of the balanced budget policy might now insist that their point had been well taken, since the above reference to a quarter of the labor force that might possibly be unemployed would constitute a concession that government action outside the balanced budget is necessary.

The conclusion would be over-hasty. The main issue at this point is whether or not the balanced budget would cause an increase in the amount of unemployment that tends to appear in a depression. We are not, as yet, concerned with how government should deal with such a situation.

Reverting to the criticism with which we began, namely that under certain circumstances the economic machine would not function well enough to permit maintenance of a balanced budget, it becomes necessary to consider the conditions under which the machine can work well. As already noted, the area of responsibility for this result is much greater than that of fiscal policy. In this connection the flexibility of wage rates becomes important, for it is plain that a given volume of employment, as, for example, that which can be provided in a period of rising prices and rising profits, cannot be maintained under the reverse conditions of falling prices and falling profits except by a revision of wage costs. The efficiency of labor does not increase rapidly enough in depressed periods to permit continuance of the wage rates established in a boom period. Hence, there must be a choice between fixed wages and employment.

The stock argument in opposition to wage revision in a depression is that it will reduce overall purchasing power. This is not necessarily true. An illustration will serve to make the point clear. Let it be assumed that in a boom period the wage income of the country is \$100 billion, earned by 50 million workers at an average wage of \$1.00 per hour for a 40-hour week and a 50-week work year. Let it be assumed further, that the inevitable changes to be produced by the transition to a depression will reduce this segment of the national income to \$75 billion. Maintenance of the wage rate of \$1.00 per hour and the 50-week work year for those who were employed at that rate would mean reduction of the number employed to 37.5 million. Thus a quarter of the labor force would be

unemployed. But if the average wage rate were reduced to \$0.75 per hour, it might be possible for all or nearly all of the labor force of 50 million to be employed through a normal work year, and if so, their total wage income would approximate \$75 billion. It is better in every respect for a large proportion of the labor force to be employed and share the wage income produced, though at lower wage rates, than for a smaller proportion of it to be employed at prosperity wage rates which are so high as to force millions into unemployment.

The point to be emphasized here is that the best method of spreading the work during a depression is not by staggering hours, or by a shorter work week, but by reducing wage rates. Government intervention, in the manner employed during the 1930's or prescribed by the Full Employment Bill, is in effect a subsidy for the prevailing rate of wages. It thus becomes a powerful deterrent to the inauguration of the forces that should emerge to produce recovery.

It should be apparent that the establishment of wage rates at a level which would sustain a maximum amount of employment through the depression would to that extent relieve government from the obligation to provide assistance. The principal risk which the balanced budget policy will encounter under depressed economic conditions is that the requirements for relief may be greater than can be financed from current revenues. The most effective way of avoiding the necessity for relief is to keep people employed. To this end primary attention must be given, by management, labor, and government, to non-fiscal policies. The Committee on Postwar Tax Policy recognized that under some circumstances a resumption of borrowing might be necessary, but resistance to such a policy was expressed: ⁸

...we see in a policy which would encourage resort to loans in lieu of taxes for budgetary purposes a powerful temptation to do this in imaginary as well as in real emergencies. Because of the natural resistance to taxation, there is every likelihood that the long-run result would be an accumulation of debt and a creeping inflation that would impair the living standards of a large proportion of the people.

The element of inevitableness in cycle theory suggests that depression necessarily gives way to recovery, just as the boom leads to depression. Such, indeed, has been the record. The forces which produce recovery are as complicated and as obscure as those which produce depression. Again the problem of proper government policy must be considered. Obviously this policy should be so designed as to avoid placing barriers in the way of the recuperative forces, for the recovery, however inevitable eventually, may be long delayed by inept government action. On this, also, experience is clear. A record of budget balance through the depression would constitute a minimum impediment to recovery. The

⁸ *Op. cit.*, p. 25.

Committee on Postwar Tax Policy expressed itself as to the effects of the contrary policy, that is, of deficits through a depression, as follows:⁹

In our opinion the effect of deficits and continued debt increase on the economy would be so serious as to warrant a strong effort to avoid them by maintaining normal budgetary balance. Deficit spending may provide some temporary relief by putting more money into circulation. The payments are likely to be made, in at least some degree, without regard to the quantity or quality of productive effort being performed by the recipients. Thus, the ground work is laid for inflation, a condition under which the higher money incomes cannot provide an equivalent real income. Furthermore, the steady increase of the public debt under a deficit policy would tend to give rise to growing doubt as to the stability of the monetary unit and the redemption value of the debt. These doubts would go far to impair that confidence in the future which is essential to bold business planning and vigorous enterprise.

As noted at the outset of this discussion, the effectiveness with which the economic machine will operate depends on many factors aside from fiscal policy. Sound measures and programs are as essential in these other fields as they are in the realm of government finance. It would be equally bad judgment to undertake correction of the mistakes in finance by manipulation of non-fiscal matters, such as wage increases to offset an inflation; or to undertake correction of the mistakes of labor, management, and price policies by manipulation of the federal budget, such as resort to inflation to offset price and wage rigidities. Thus far there has been an unfortunate tendency to look upon the budget as the shock absorber of the errors in other fields. Given even half a chance through a reversal of this tendency by a statesmanlike approach to the other problems involved in the proper functioning of the economy, the economic machine can operate well under a balanced federal budget.

Ordinary economic logic suggests that budget balance would be a wholesome and stimulating influence, particularly under the prospects which now confront the nation regarding the volume of debt and of debt service to be carried. The balanced budget would be an assurance against further inflationary policies and pressures, and against such doubts as might otherwise develop regarding the future value of the debt and the currency. It would also be an assurance against any large volume of government "made work" and against the threat of extensive government competition with private enterprise through the making of so-called "investments" or otherwise.

The principal argument that is advanced against the policy of budgetary balance is, that under it purchasing power will be insufficient to absorb the product of reasonably full employment. Hence support has developed for some sort of government action to assure equalization of production and spending. Two lines of such action have been advocated.

⁹ *Op. cit.*, p. 23.

One is deficit operations for the purpose, primarily, of supplying the people with more money to spend. The other is a program of taxing and borrowing aimed at forcing the available income into use. The first proposal rests on the hypothesis that the productive process will simply not generate enough income with which to absorb the goods and services produced. The second proposal appears to recognize that there is income enough, but assumes that some of it will remain idle unless driven into the open by government action.

The popularity of the doctrine that purchasing power will be less than the amount required to absorb the goods produced, unless supplemented by inflationary deficits, must be ascribed to reasons other than economic analysis. If we look at the way the economic process works, we find that all production involve costs; that is, goods are not and cannot be produced without involving cost payments. These payments are made to the workers, to the suppliers of materials and machinery, and to those who provide the capital. By and large they are an important determinant of the value of the goods produced. That part of the return to capital which is known as profit is not a direct and immediate element of cost, but it is well understood that in the long run the value must include a return of this sort which is accepted as satisfactory, in view of the risks involved, or capital supplies will not be forthcoming. Since the costs incurred by producers constitute income to others, including the compensation of the producers or managers themselves, and since the costs bulk so large as a determinant of the value created, it would appear that the act of production always creates income for someone, somewhere. The aggregate of the incomes so created should normally tend to equal the aggregate value of the goods produced.

Various reasons have been given in explanation of the assumed deficiency in purchasing power. One implication, which can be traced at least from Rodbertus, is that purchasing power is insufficient because the workers do not receive, as wages, an amount equal to the full value of the goods produced. The full equation of income against goods, however, must include not only wages and salaries, but all other forms of income. The wage controversy is frequently stated in terms which ignore the importance of shareholders and other investors, both as the providers of the capital that made the employment of labor possible, and as recipients and spenders of a portion of the income paid out. It cannot be too often emphasized that this is not merely a contrast between rich stockholders and poor workers. The Committee on Postwar Tax Policy has shown that the proportion of all dividends reported by individuals which is reported in the low income brackets has been increasing, and that this proportion now constitutes an impressive fraction of the total of such dividends.¹⁰

¹⁰ *Op. cit.*, Ch. 5, especially pp. 69-73.

At this point we encounter the second of the hypotheses set out above, namely, that the total income actually used as purchasing power is deficient because of a disposition to save rather than consume. It is contended that the propensity to save is great enough to involve withholding considerable income, in the aggregate, from the market, and that this withheld income will upset the balance between production and spending.

According to the Marxian argument, the capitalist exploiters squeezed wages down and they neither could nor would spend all of the income thus wrongfully withheld from the workers. The course of events has exploded the labor exploitation theory and the modern version accepts as fairly widespread the propensity to save, although those in the higher income brackets will naturally have the most effective opportunity for exercising this bent.

The motives for saving are various. An important one is the desire to secure a return through investment. But investment is spending in another form—for capital rather than for consumer goods. Both forms of spending lead to income receipts by workers as well as investors.

Any economically well-developed community will tend to establish a certain balance between spending for capital goods and spending for consumer goods. An example of extreme emphasis upon capital goods has been provided by Soviet Russia, where the great dearth of such goods led to a policy of heavy concentration upon this type of spending, with a corresponding curtailment of spending for consumption goods. Germany followed a similar course during the years of war preparation, as did the United States under the defense and war programs.

In a free economy, already well equipped with the facilities of production, the distribution of total spending between these classes will be governed in part by the comparative advantage in terms of return and in part by the current status of technological improvement.

With respect to the rate of return, the person who has saved a sum out of current income in order to invest has a choice between putting his money into the production of capital or consumer goods. He may engage in making tools, or he may buy tools made by others with a view to producing consumer goods. The relative prospects of return, having due regard to the risks, tend to apportion the investment flow. In so far as gain is a determining motive in saving, the potential saver always has a third option when the return from any kind of investment no longer is such as to warrant the effort and abstinence involved. This is to consume more rather than save.

A second important motive for saving is future security, for one's self or for one's dependents. Here the emphasis is usually upon safety of principal rather than upon return, though the latter consideration is seldom wholly absent. The immense amounts of income that flow currently into savings deposits, life insurance, home ownership, and other

forms of accumulation which point toward security, indicate widespread, persistent operation of this motive.

Two things should be noted, however, with respect to this process. The first is that the institutions which accept these savings are impelled to find an investment placement for them in order to earn such rate of return, however moderate, as may be paid thereon; and in order, also, to cover their own expense of administering such funds. The second thing to be noted is that realization of the security goal will, at some time, very likely involve the expenditure of the funds accumulated. The savings deposit will be drawn down when necessary. The dependents of an insured person will spend the proceeds of the life insurance policy. This tendency, which is also widespread, means that funds withdrawn from current income do not remain locked up permanently. There are large withdrawals, particularly in the periods when incomes from other sources are impaired, that is, when a general deficiency of purchasing power may be most apparent.

To this point we have dealt with the general assumption that over-saving may become a serious deterrent to the sale of current product. In so far as an investment return is influential, the decline of this return should operate as a brake. To the extent that security is the motive, there is a counter-balancing expenditure at some time, on a scale which may more than offset, in certain periods, the current additions to the security accumulation.

The effect of the rate of return upon the volume of savings is often questioned, in the postulate that despite the drying up of investment outlets the savings continue to be piled up. This has given rise to various suggestions for siphoning off funds which, having been more or less automatically accumulated as a matter of habit, must remain idle due to the lack of an investment outlet.

The progressive income tax is sometimes justified on this basis, among others. The difficulty is in the inability to exercise a proper discrimination between that portion of income which is to remain idle and that portion which, though inactive on tax-reporting day, is actually destined for an investment use. It is believed by some that a periodic inventory of assets would disclose the degree to which hoarding of income exists. Quite apart from the administrative difficulties of such a procedure, its results would be far from infallible, unless it is to be assumed that the pressure of such tax as might be imposed on cash balances would be effective in stimulating the owners to find a useful outlet at once, or to consume to excess in order to escape the tax.

The rate at which saved funds move into investment may properly be quite different from the rate at which saving occurs. The latter normally proceeds with fair regularity, since the bulk of income moves into the hands of its recipients as a more or less steady flow. Investment is

likely to occur by spurts, both because of the need of accumulating an amount sufficient for the intended investment purpose, and also because of the variations of investment opportunity arising from technological improvement. Possession of a cash balance at the year-end would be no clear indication that it was to be permanently hoarded.

With respect to technical improvements, economists have long been aware that economic progress is not necessarily a smooth advance at some regular rate per year. Inventions and discoveries of practical economic significance do not occur according to a pre-designed time-table. As each appears, there is created a great demand for new capital investment, but this demand does not remain at the flood in the interim between one epoch-making development and the next. However, it was never sensible or realistic to assume that all outlet for new capital investment disappeared during these intervals, and far less so to assert that our economy had sufficiently matured to warrant no further great expectations. At the very time when gloomy forecasts of this nature were being made so freely, the physicists and mathematicians were approaching a practical solution of the problem of atomic fission, the bare prospect of which, in its applications to peace-time economic activity and the amount of capital investment required, staggers the imagination.

Nevertheless, technological advance is sometimes cited as a cause of a deficiency of purchasing power, since it results in a greater output per man-hour of labor. Because of this changed relationship, the supply of goods is assumed to increase faster than the total of wage payments. In so far as this line of argument is accepted, it evidently ignores the fact that every improvement in technology requires additional capital investment. Where the innovation has far-reaching consequences, the volume of additional capital needed becomes enormous. The payments to secure the use of this capital must be reckoned with in balancing up the account between purchasing power and goods. Moreover, the history of technological advance shows that the overall opportunities for labor as well as for investment have been expanded rather than diminished by reason of the advance. The diffusion of the benefits spreads outward in ever-widening circles. Goods that once were scarce and high, available as luxuries only to the few, become part of the accepted list of comforts, or even of necessities, for the many. The temporary, and usually short-lived displacement of workers by an improved process has long been recognized and catalogued as "technological unemployment." That the shrinkage in purchasing power occasioned by this condition is transient is demonstrated by the steady growth of both the labor force and the volume of wage payments as accompaniments of the introduction of one great mechanical improvement after another.

It may be noted that the introduction of improvements in machinery and in industrial processes is likely to proceed at a more rapid rate when

there is freedom to write off the cost according to the dictates of managerial judgment than when the tax law and the regulations insist upon depreciation schedules adjusted to the maximum useful life of the depreciable equipment. The latter policy tends to prevent industry from keeping pace with the known improvements, and thus probably tends to lessen the intensity of the search for further improvements. While the tax law cannot prevent management from establishing, for company purposes, a greater depreciation rate than would be accepted by the Treasury for tax purposes, the penalty on such a policy under a substantial rate of corporation income tax would go far to neutralize the benefits sought from the acceleration. It requires no argument to demonstrate that restrictions on depreciation practice deter the introduction of improvements and hence prevent prompt realization of possible cost and price reductions. To the extent that these results are produced, production volume and employment opportunities are restricted and the revenue purpose is also defeated.

Is there, then, any serious danger that over-saving will persist until it attains proportions which would aggravate unemployment by causing a grave deficiency in purchasing power? In this writer's opinion the answer should be in the negative, for two reasons. The first is the self-corrective influence of the gain motive upon accumulation, together with the ultimate expenditure of the funds saved for security purposes. The second is the lack of evidence that the nation has reached the limits of investment expansion. Particular industries or firms may approach the limit of further profitable growth, since the market for any given article can become saturated. This would not be true of all goods, however, because of the indefinite expansibility of human wants. Variation of the methods or the direction of production, leading to new or improved products is always available where there are ingenuity and capital for the development. These steps always lead to a new market. The impressive fact in the record of our industrial expansion is that the buying power for the new market is always there. The process of creating the new goods creates, also, the income with which to buy them.

It is not to be inferred, however, that consumer buying is always automatic, any more than it is to be assumed that saving is always automatic. Consumers buy selectively and the price, under normal conditions, is an important factor in their decisions. The first condition of selling is to have something for sale which consumers want. To the other causes of unemployment should be added that of "missing the boat." When labor and capital have been applied to making something for which there is no market, such as last year's hats for ladies, unemployment is likely to emerge rather quickly for the workers involved in the ill-fated enterprise. But when a firm closes because its product cannot be sold, the owners of the capital also lose unless they have sufficient ingenuity to develop

some other line that can be made with the equipment in hand. In such a case the unemployment is likely to be short.

The principal impediment to sales is the price. Technically defined, price is value expressed in terms of money. Where there is an impression of insufficient purchasing power, it is caused by the disparity between price and available money to spend. The failure of consumers as a whole to clear the market of the goods and services produced may be quite as much the result of the prices asked as of too little money in the hands of consumers.

Abnormal or excessive prices may result from monopolistic control or from some extraordinary rigidity of costs under competition. The problems of monopoly and near monopoly are outside the scope of the present discussion. It is sufficient to say, with regard to such practices, that they are inimical to the free and effective operation of the private enterprise system. To this should be added the observation that bigness alone is no necessary indication of monopoly and that an approach predicated on the identity of mere size with monopoly would lead in many cases to a whittling down of productive efficiency as well as of supposed monopolistic practices.

A popular but fallacious remedy for the suffocation symptoms so often diagnosed as purchasing power deficiency is to provide the people with more money to spend. The remedy is popular because one does not have to work, or work as hard, for the income received in doing "made work," or useless work like digging and filling holes, as one does to earn income in competitive industry. The remedy is fallacious because prices are capable of rising faster than the amount of the money hand-out and they usually do so under this sort of inflationary stimulus.

A far more effective remedy for the symptoms referred to is production at lower cost. This course not only relieves the sensation of purchasing power shortage, it also assures an improvement in the real standard of living. Cost reduction, as the necessary prerequisite to price reduction, may be achieved in various ways, important among which are improvements in technology and wage adjustments. When technical advance is sufficiently rapid, good wages can be and usually are paid without interfering with the decline in unit costs. Wage demands can be pushed to an extent, however, which would prohibit the producer from sharing the benefits of greater efficiency with the consumers through price reductions.

The maintenance of a demand sufficient to absorb the output of an economic system that is operating at a satisfactory employment level is, therefore, fully as much a problem of keeping down costs and prices as it is one of providing the people with more money for spending. The productive process itself generates income, and as the fruits of greater efficiency are passed along through price reductions the people will have

an ample amount of buying power to absorb all products having want-satisfying qualities. Progress in this direction is the surest way to elevate the real standard of living.

On the other hand, the attempt to solve the problem by an artificial increase of purchasing power tends to make a bad situation worse. The effort to overcome the price-money disparity by creating more money promotes disregard of costs and prices, while the process contributes to the increase of both. It is ordinarily not possible to distribute the new money widely enough to enable all consumers to fare well in the struggle against rising prices, and the result is a declining real standard of living for those who fail to get a share of the largess.

So far as is possible in this brief space, we have sought to dispose of some of the arguments most commonly advanced to justify an unbalanced budget. The conclusion to which these arguments lead, in the thinking of those who stress them, is that their consequences should be offset, where necessary, by budgetary manipulation. This conclusion is rejected here for reasons already stated, namely, that we get nowhere by undertaking to correct the errors of policy or defects of practice in non-fiscal fields, by such means. The fiscal powers are great enough to produce results which would temporarily yield an impression of being remedially effective. But their very extent and force are such that they inevitably produce, under mismanagement, worse evils than those to which they are applied as a corrective, and for which no remedy or control exists.

The problem of budgetary policy may be reduced, in essence, to the question of when, if ever, there should be a condition of balance between receipts and payments. Various answers have been proposed. Some would approve a balance only in the most prosperous years when, it is usually added, "there will be a large national income and full employment." Others would include "normal" years as well as prosperous years, although the difficulty of identifying a normal year is obvious. Still others would call for a balanced budget as the regular fiscal practice to be followed consistently, notwithstanding considerable variation in economic conditions.

The tolerance of budget deficits in these varying views is, of course, inverse to the attitude toward a balanced condition. The basis of such tolerance is ordinarily a belief that the alternative to a balanced budget is, under some circumstances, a lesser evil than a balanced condition. The situation which is most often brought in as being one involving a greater evil than a deficit, is unemployment. Advocates of a balanced budget as the regular fiscal practice are denounced as stony-hearted Tories who are utterly indifferent to the suffering and distress of those who are without work and income. On the other hand, the increase of debt for the purpose of providing relief to those without jobs is hailed as the acme of justice and humanitarianism.

The choice, in a depression, is not necessarily between budget balance and widespread distress. There is a definite responsibility, which government must share with individuals, for the relief of distress. We have never tried to discharge this responsibility under a balanced budget, adequately supported by a diversified tax system and supplemented by the huge fund accumulated from the proceeds of the unemployment compensation taxes. Without a fair trial it will never be known for certain whether or not it can be done. The choice of policies therefore lies between the following alternatives—first, doing those things which will tend to hold unemployment at a minimum and providing the needed relief under a balanced budget; and second, ignoring the remedial measures and the balanced budget by prompt resort to deficit financing.

Various factors have contributed to the readiness with which the second of the above alternatives has been adopted. In the first place, taxation is currently burdensome, whereas the full burden of debt becomes apparent only at a later time. Secondly, there is the failure to recognize that unemployment is a symptom of fundamental maladjustments and that spending to relieve the symptom is no cure for the disease which produces it. Finally, the public debt has been rationalized and is exalted to the high position of a beneficent and fructifying element in the economy. The remoteness of its burden has contributed greatly to belief in its supposed advantages. Having accepted in so large degree this rationalization of the debt, resort to it becomes an acceptable means of escape from dealing with the more troublesome maladjustments which exist. It thus becomes easy to regard the budget as the absorber of all shocks experienced by the economy.

The primary purpose here is to challenge the concept of the debt as a beneficent element in the economy. Before proceeding with this subject, it is desirable to repeat, for emphasis, some points that have been made earlier with respect to unemployment as a symptom rather than an original cause.”¹¹

A popular, but in this writer's opinion, fallacious explanation of unemployment is that it is caused by a deficiency of purchasing power. The employer, it is said, cannot maintain sales because of a lack of purchasing power, hence he must discharge workers. The loss of income by these workers causes sales volume elsewhere to decline, thereby leading to more lay-offs, a further loss of purchasing power, and so on.

This explanation is faulty in that it ignores the actual sequence of events, which is that the lay-off precedes the loss of income. There may be cumulative developments once unemployment has begun, but the theory does not adequately explain why the first employers who reduce production must do so, since, up to that time, all workers have been paid regularly and there could have been no decline of income until after the

¹¹ Cf. *The Tax Review*, October and December, 1945.

lay-offs had begun. It also ignores all of the other factors and conditions which can and do interrupt production.

It is doubtful if it be possible, through any sort of action, to prevent the emergence of all these interrupting factors and conditions. Ability to do so would mean ability to abolish the economic cycle. Until there is agreement, on a demonstrated empirical basis, as to what are the causes of economic cycles, formulation of a control policy would be difficult. Even complete regimentation would hardly suffice, to the extent that international influences may contribute, and it would in any case be too high a price to pay for the experiment.

We do know, however, from experience, that reversals of trend from boom to depression have been intensified by various errors of policy. These errors have been, by far the greater part, in non-fiscal fields. They include bad bank and other private credit policy, ill-advised construction, improper foreign trade practices, indefensible wage-cost-price relationships, and many other things. Each is a thorny subject to handle, both as an objective economic problem and as an emotional, political issue.

Nevertheless, it is with fundamental maladjustments of the sort mentioned above that we must deal if we are to get down to the roots of the difficulty of which unemployment is a symptom. The government's budget policy has no relation to this task. Whether it be balanced or not is of no consequence, so far as concerns the essential problem of understanding the economic cycle and of avoiding the numerous mistakes which, at least, intensify it.

The doctrines that have been recently popularized relative to the rôle of fiscal policy have been detrimental, both to a proper understanding of the central problem and to the formulation of correct measures for undertaking to deal with it. So great is the faith that mere spending, in sufficient amount, is a cure-all, and so successful has been the job of rationalizing the public debt as a good thing, *per se*, that it has become virtually impossible to gain public support for more constructive measures or to direct public attention toward consideration of the basic issues.

It is highly important that the problem of large-scale unemployment be dealt with in ways more fundamental than public spending. Budgetary deficits do not really provide employment in the ordinary and accepted meaning of this term. They are, rather, a method of providing relief. It will be argued that some of the things done under emergency appropriations are useful additions to the community's stock of public capital goods. This may be true, but the utility of the goods created would be as great if they were paid for out of current revenues as it would be if they were financed by budgetary deficits. Neither the method of financing nor the timing of the operation have any bearing on the usefulness of the things done. The fact that it is proposed to do them at a time when unemployment exists is an indication that the relief motive is paramount.

We turn now to the arguments that have been advanced in support of the alleged advantages of public debt.

The first argument is that a public debt is beneficial because it supplies a backlog of safe, highly liquid investment paper for financial institutions such as banks and insurance companies. It is said, also, to provide an element of security to those with sizeable fortunes, who are thus the more readily inclined to make venturesome investments with a portion of their capital. Professor Hansen has expounded this view in his book entitled, *Fiscal Policy and Business Cycles*.¹²

This argument cannot be used to prove that a public debt is essential to the stability of banks and insurance companies, or to the growth of risk investments. At best it will serve to postulate certain advantages deemed to be supplied by the existence of a debt, provided one is not required to show that private financial institutions could not have developed stature and strength had the debt not existed. Furthermore, it is evident that such benefits of the above sorts as can properly be claimed are realizable from a small or moderate debt. In fact, it would appear that their realization would be much more likely if the debt were of moderate size. Genuine liquidity for debt or other negotiable paper involves such market demand and support as to assure any specific holder the opportunity of sale without loss. With a huge debt there would be far greater likelihood of severe price changes in the event that holders of substantial amount sought to liquidate. The sharp decline of the Liberty Bonds after World War I is a case in point. It is well understood that debt holders today must refrain from large-scale selling, by mutual consent, and for strong reasons of mutual protection. Liquidity achieved by the support of the central banks and the Treasury is artificial and precarious, hence none too reassuring to institutional or individual investors.

No elaboration of the point is needed to show that a huge debt, by its very size, is a menace to its own safety and security. These attributes rest on the productive capacity and energy of the people since the government cannot, by any economic legerdemain, support the value of its own debt. Even the open market operations by which an effort might be made to prevent serious price decline involve further juggling with credit resources or with the creation of fiat currency. A huge debt will always present, also, the prospect of efforts to lighten the debt load by further currency devaluation, a case for which would be offered on the ground that the action would be only a legalization of a condition made factual by the size of the debt itself.

It is unnecessary to debate at length the question whether or not some public debt may be advantageous. It seems clear that such benefits as may exist are far more likely to be realized with a small than with a large debt.

¹² Alvin H. Hansen, *Fiscal Policy and Business Cycles*, Ch. IX, "The Growth and Role of Public Debt" (New York, 1941).

As an illustration of relative magnitudes, it is suggested that a debt equal to 10 per cent of the value of the nation's productive equipment would far better satisfy this requirement than a debt equalling 150 per cent of that value.

A second line of argument in a rationalization of the public debt is that it will contribute to an expanding economy and to the attainment of full employment. This position requires a more or less continuous increase of the debt, which naturally involves no effort at redemption.

Various doctrines have been advanced to support this general viewpoint. One is that an internal debt is no burden since "we owe it to ourselves." An illustration of this idea is provided by a pamphlet issued by the National Resources Planning Board in 1942. The following is taken from that publication:¹³

Stated broadly, we should keep clearly in mind the fact that balanced against the taxes required to cover interest charges are the interest receipts of institutions and individuals who own the bonds. Thus the fact is that our public debt, owned as it is mainly by institutions performing useful and necessary services, is no such burden on the community as is commonly supposed. The tax funds collected to meet interest charges are not lost. They are paid right back again, largely to institutions that benefit the community as a whole. At the worst, the taxes are collected from one group of citizens and paid out to another group—the bondholders.

This passage correctly describes the transfer character of taxing and spending. The money goes in and comes out. The inference is that the size of the debt, and therefore the size of the transfer payments for debt service are of no consequence, which means that the debt itself may as well be as large as a small one. What is overlooked, or at least not made clear in the discussion from which the above passage is excerpted, is the effect upon the taxpayers. If the taxes for debt service, or for other purposes, become heavy enough to impair the incentives of those who must pay them, production, employment, and income are adversely affected. The bad effects thus produced are by no means offset by the fact that other members of the community are receiving the funds paid out as interest on the public debt.

A third approach to the proposition that public debt is a good thing rests on the supposed advantage of an expanding debt. The increase is said to be justified, provided the rising interest cost does not absorb a greater proportion of national income. This view is presented in Sir William Beveridge's book.¹⁴ It is stated there that as part of a full employment policy it may be necessary to reckon with a steadily rising debt in peace-time. Kaldor, who contributed a long appendix to the book, recog-

¹³ National Resources Planning Board, *After the War—Full Employment*, by Alvin H. Hansen, Washington, January, 1942.

¹⁴ William Beveridge, *Full Employment in a Free Society*, Appendix C, by Nicholas Kaldor, especially pp. 394-401.

nizes the possibility of adverse effects from heavier taxes for debt service, despite their transfer character, but he holds that this need not occur, provided the rising cost of debt service does not require a larger proportion of the national income.

The argument rests on the assumption that output per man hour will continue to increase in the future as heretofore, as a result of technical progress and the accumulation of capital. After allowance for changes in the British working population produced by the shift of a greater proportion of the whole population into the higher age groups, for a shortening of the work week, and for changes in the price level, he concludes that a steady rise of the national income will occur. Government, it is asserted, can therefore continue to borrow up to the point at which an established constant ratio of interest payment to national income would not be disturbed. Without here entering into the details of the calculation, it may suffice to note that at an average interest rate of 2 per cent, Kaldor estimates that the British Government could borrow as much as £775 million per annum over the period 1948-1970 without having to raise any new taxes for the maintenance of budgetary equilibrium.¹⁵ The estimates are said to hold regardless of what is done with the borrowed funds. "... they hold even if the loan money is spent on objects of current consumption, or on completely useless purposes, such as digging holes and filling them up again."

A characteristic failing of the planners, "do-gooders," and other brands of reformers has always been their ignorance of, or their indifference to, the economic system upon which they seek to foist their foolish ideas. As this writer has said earlier, they evidently assume ¹⁶

... that the whole enormous complex of productive factors and forces is here to stay, that it is indestructible, that it will continue automatically through an indefinite future to grind out a grist of goods and services so huge as to flood us with an embarrassing abundance of riches, and that its maintenance, preservation, and enlargement are matters of no concern.

Thus, in the discussion by Beveridge and Kaldor, cited above, it is assumed that technical progress and capital accumulation will continue as heretofore, regardless of the foolish, possibly hostile, acts of government. This could be true only if invention, saving, and investment were as automatic as breathing. It could be true only if the workers, individually or through their organizations, never imposed restrictions on output or hindered in other ways the expansion of production and the lowering of costs.

There is a still more fundamental fallacy in the argument under discussion. It involves a confusion of thought regarding the significance

¹⁵ Beveridge, *op. cit.*, p. 400.

¹⁶ H. L. Lutz, *Guideposts to a Free Economy*, Ch. III, p. 24.

of the national income concept. Britain is told by Beveridge and Kaldor that the use made of the loan funds is of no consequence. The national income will rise because of the borrowing regardless of the purpose for which the borrowed funds are spent. This is true, since the effect of the borrowing will be an inflation of prices which will automatically create the illusion of a greater national income and a more ample prosperity. But the inference which these authors expect the British people to derive, namely, that a higher level of well-being will thereby be attained, is wholly unwarranted. They will merely pay higher prices for no greater volume of consumable goods and services than existed before. Such a result will be hastened by devoting the loan funds to useless purposes, for their only contribution to national income in that event is through price inflation.

A fourth argument in support of a public debt is that it is a means of providing certain public assets which contribute a flow of real income to the citizens. Thus, debt issued to provide roads, public buildings, parks, etc., is deemed to be a beneficent influence. The so-called "value" of these assets is sometimes deducted from the gross debt to demonstrate how small is the net debt burden.¹⁷

It is obvious, of course, that a certain equipment of public buildings, roads, and other facilities is useful and necessary. But the utility of this equipment has no relation whatever to the manner of its financing, although the public debt argument is often used to imply that in some way the utility is greater if borrowed funds are used. The case for loan financing of non-liquidating capital improvements should depend, not on the character of the project but on its size in relation to the resources of the district that undertakes it. For example, a small school district would need to borrow the funds for a new school building, but a large city which required an additional school building every year on account of the growth of its school population might as well treat the cost as a current expense.¹⁸

Moreover, a sound application of the principle necessarily involves retirement of the debt within the useful life of the improvement. The flow of benefits from it ceases with the end of its useful life. If the original debt has not been retired, and if new debt is issued to replace the facility, a community which follows such a policy will eventually owe the money for several sets of roads and public buildings while still having only one set in use. No state now permits its local subdivisions to indulge in profligacy of this sort. The modern public debt cult, with its teaching that public credit is an instrument of policy, and that the obligation incurred may be kept or disregarded according to the dictates of some

¹⁷ For an illustration of this procedure, cf. *The Budget Message of the President for the Fiscal Year ending June 30, 1940*, pp. x, xi.

¹⁸ For a more complete discussion, cf. *supra*, pp. 541, 542.

broader aspect of policy, is responsible for the view that national debt is mysteriously different from the debt of private individuals or corporations.

It is appropriate to summarize briefly the argument in this discussion of budget policy:

1. The effectiveness with which the economic machine will operate depends on many factors aside from fiscal policy. Sound measures and programs are as essential in these other fields as they are in the realm of government finance. The people have been misled, and are in danger of being betrayed, by the false teaching that through manipulation of fiscal policy all other errors can be neutralized or written off. The budget should not be used as the shock absorber against all sorts of economic and political mistakes.

2. Budgetary balance is feared by some on the ground that it does not counteract the deficiencies in purchasing power said to arise from over-saving. Consideration of the motives for saving suggests that insofar as the investment return is influential, its disappearance would halt the saving process; and that, insofar as the security purpose is dominant, the subsequent attainment of this goal will involve spending. To overcome an apparent deficiency in purchasing power through production at lower cost and sale at lower prices is far more effective than by providing the people with more money to spend through budgetary deficits.

3. Any advantage that can be claimed for the debt as a stabilizing investment medium will be far better realized from a small than a large debt. On the other hand, continuous debt increase for the purpose of expanding the national income produces this effect through price inflation. Such result becomes more definitely certain when the loan funds are devoted to unproductive uses.

It follows, therefore, that we have no valid basis on which to rationalize the existing public debt as a beneficent influence. It should be recognized as a serious problem. Instead of adding to it, even for purposes of such primary importance as the relief of unemployment, we should plan to deal with this and other problems in ways that will avoid further debt increase. Once we shall have agreed that this apparently easy way of meeting even the real emergencies, not to mention the many imaginary ones, is to be hereafter closed, we can face up to the job of handling them inside the budget. And this, in the long run, will really be the easy way.

CHAPTER XXXIX

The Custody of Public Funds

A FINAL TOPIC is the custody of public funds. By the act of collecting the public receipts the government draws purchasing power from the vast stream of social income. These funds are returned again through other channels in the process of satisfying the public needs. During the life history of the public funds, as Hilton Young puts it, "from their cradle in the taxpayers' pocket to their grave in the pocket of the government's creditors," there must be some means for securing proper public custody of these funds, and of providing adequate means of collection, safe-keeping, transfer and disbursement. This subject involves technical matters of accounting procedure that will be passed over. Attention is directed rather to the relation of the governmental fiscal agencies to the economic institutions which serve the community at large in the parallel purposes of handling the funds of individuals and of business concerns.

The technique of public collection and disbursement will depend, naturally, upon economic conditions. Before the money economy was generally established, public as well as private payments were largely made in kind, that is, in produce. Collectors of revenue were obliged to store the goods received, and to transport them to the places where they would be needed. There is more than one record of the tribulations of colonial collectors of revenue as they were bringing in the peas, tobacco, corn and other commodities receivable for taxes, over the wretched roads and across the swollen streams which had, of necessity, to be forded. During the period of the use of money which antedated the rise of banking and credit institutions, payments were made in currency, and this, too, had to be stored and transported as needed. The general use of credit instruments and credit institutions in carrying on exchanges of all sorts afforded the opportunity of utilizing these improved methods in conducting public financial operations.

The methods of managing the public finances have not universally kept pace with these developments of private economic life. Two alternative policies present themselves, both of which have been followed at different times and in different countries. One is the policy of physical isolation and the segregation of the government funds, the collection of

all revenue into a public treasury, from which in turn all public disbursements are made. The other is the policy of accepting and utilizing the established banking and other financial institutions of the country as the custodians of the public funds, and the adaptation of the mechanism of collection and disbursement of the public moneys to the ordinary banking procedure followed by the community at large. In other words, it is the contrast between the independent treasury as the sole custodian of the government's money and its sole fiscal agent in all financial transactions with the people, and the modern banking system serving in these capacities.

The isolated public treasury is a relic of the medieval days when there were no banks, and when trust and confidence in commercial relations were unknown, or but feebly developed. This policy appears so incongruous today that all reference to it would be omitted had not the federal government at one time employed it in the management of its funds. Similar methods have also been used by the states at different times. It has been impossible to maintain that strict segregation of the public money which the theory of the independent treasury demands, but the idea of such an institution died hard, and some vestiges of the system still remain, although its most important characteristics have been swept away.

The best method of approach to these aspects of the subject of treasury organization and functions that are to be treated here will be, perhaps, to outline first the method followed in England for keeping and handling public funds, and then turn to the federal system for the same purpose. The fiscal practices of some of the states will also receive brief reference in the following pages.

THE CUSTODY OF PUBLIC FUNDS IN ENGLAND

In order to understand the English system of handling and administering the public funds it is necessary to recall the peculiar meaning which is there given to the word *treasury*. The English Treasury is no longer the place where the treasure, in the sense of the public money, is kept, although this was of course its original meaning.¹ As noted in the preceding chapter, the English Treasury is simply an administrative organization. The Chancellor of the Exchequer, who is usually the Second Lord of the

¹ The Exchequer was originally the agency to which the King's debtor had to account, and his creditors to apply for payment. The word is probably derived from *eschace* (old French), a stick. "The connection comes from the fact that the accounts were once kept by means of notched sticks, or tallies. A complicated system of settling accounts by means of counters on a table laid off in squares antedated the modern system of account-keeping, and in time the Exchequer became the place in which the settlement was made, and thus, the Treasury. It is interesting to note that the notched tallies were not entirely dispensed with until 1833. Cf. R. L. Poole, *The Exchequer in the Twelfth Century* (1912), pp. 89, 91.

Treasury, is in direct charge of financial matters, including income and expenditure, taxation, the public debt, and the supervision of banking and currency legislation. He is also *ex officio* Master of the Mint.²

The Bank of England. The English government has not undertaken the task of the physical storage, safe-keeping and disbursement of its moneys for more than two centuries. Since the establishment of the Bank of England, in 1694, this institution has had the privilege of public depositary as one of the rewards for the financial services rendered by it to the government. The policy of governmental reliance upon banking institutions goes back, in England, to the beginning of modern banking. This policy has not had the unanimous approval of all students of the English system, although the latter have directed their fire rather at the manner in which the Bank has viewed its responsibilities than at the government's use of it as a depositary and fiscal agent.³ Certainly this aspect of the English financial procedure is so well settled that its abandonment is most unlikely, despite any changes that may have been made as the bank was transferred from private to public ownership.

The Bank of England performs for its largest and most important customer the same services of a banking nature which it performs for those private citizens who, as one writer puts it, are rich and respectable enough to have accounts there. That is, it receives the government deposits, places them to the Exchequer account, transfers sums to the various appropriation accounts in accordance with instructions from the Treasury, and pays the government's checks and drafts against these accounts as they come in. Any taxpayer in the kingdom may pay his taxes and other public dues by no greater formality than that of writing a check against his own bank account and forwarding this to the appropriate collector of the revenues. As these checks are deposited, a series of entries transfer the credits from the taxpayer's account in his own bank to the government's account at the Bank of England. There is no obligation to tender any specified form of currency, no withdrawal of currency or circulating medium from general use, no segregation of money into a government strong-box to be held there until released by the process of public disbursement.⁴

The procedure for handling the public funds is now governed by the Exchequer and Audit Act of 1866. The various collectors of revenue are required to deposit their receipts to the "Account of Her Majesty's Exchequer at the Bank of England and at the Bank of Ireland respectively, and all other public moneys payable to the Exchequer shall be paid

² See H. Higgs, *The Financial System of the United Kingdom*, Ch. VII.

³ E. g., W. Bagehot, *Lombard Street*. Cf. also E. Hilton Young, *The System of National Finance*, pp. 342 ff.

⁴ Young, *op. cit.*, pp. 242 ff., contends that the accumulation of government deposits has an effect similar to isolation, and suggests several reforms which he believes would mitigate the undesirable effects produced.

to the same accounts. . . .”⁵ The formalities of disbursement are thus set forth in another section of the above act:

15. When any ways and means shall have been granted by Parliament to make good supplies to Her Majesty by any Act of Parliament or resolution of the House of Commons, the Comptroller and Auditor-General shall grant to the Treasury, on their requisition authorizing the same, a credit or credits on the Exchequer accounts at the Bank of England and Bank of Ireland, or on the growing balances thereof, not exceeding in the whole the amount of the ways and means so granted. Out of the credits so granted to the Treasury issues shall be made to principal accountants from time to time on orders issued to the said banks, signed by one of the Secretaries of the Treasury, or in their absence by such officer or officers as the Treasury may from time to time appoint to that duty; and the services or votes on account of which the issues may be authorized shall be set forth in such orders: Provided always, that the issues for Army and Navy services shall be made under the general heads of “Army” and “Navy” respectively.

The checks drawn by the various disbursing officers in payment of the public expenses are normally deposited by the government creditors to their own bank accounts, and a final series of bookkeeping entries completes the cycle of revenue collection and disbursement. The utilization of the established banking institutions of the country permits this process to go on continuously as a part of the larger use of the mechanism of bank credits which the business community has developed for fulfilling the needs of modern economic organization.

The Bank of England as fiscal agent. In addition to acting as public depository, the Bank of England serves also as the fiscal agent of the British Government. In this capacity it manages the public debt by keeping the books in which the names of owners of the government stock are recorded, and recording therein the transfers of ownership. This is an important service, for there is nearly always an active market in Consols, and it is necessary to be able to effect transfer quickly. New issues of the debt are floated through the agency of the Bank, as well as the issue and repayment of Treasury Bills and Exchequer Bonds. Finally, the Bank is the agent for the issue of coin and the withdrawal of light weight coins from circulation.

While the bank was privately owned, its compensation for these various services was fixed by statute. Now that it has been nationalized, the arrangements made are wholly subject to governmental discretion. The fact that payments must be made on the securities issued to the former owners of the stock would indicate that in some way the bank's operations are to show an income.

⁵ 29 and 30 *Victoria*, c. 39, Section 10.

THE CUSTODY OF THE FUNDS OF THE FEDERAL GOVERNMENT

The treasury system. The experience of the federal government in handling its funds has been in marked contrast to the relatively simple procedure which has developed in England. The original Treasury Act of 1789 provided for an organization, but took no steps toward the creation of a separate physical treasury. The internal organization, though clumsy, was well-nigh perfect as a system of checks to prevent the withdrawal of money from the treasury except on proper warrants. But this treasury, which was thus so jealously hedged about with checks and safeguards, existed nowhere.

From the beginning of the federal government the public moneys were kept in various banks as depositary agents. The First Bank of the United States served in this capacity between 1791 and 1811 and from 1816 to 1833 the Second Bank performed this service. During the interim 1811-1816 the government funds were deposited in various banks, some of which suspended payments during the panic of 1814. The use of the Second Bank as a public depositary ceased in 1833 as a move in the bank war being waged between President Jackson and Nicholas Biddle, the head of the bank. The state banks thereafter used as depositaries, known as "pet" banks, became seriously involved during the panic of 1837 and the depression which followed. While the government did not actually suffer loss, the experience was considered to be final and conclusive proof of the dangers of dependence on the banking system, and public sentiment, always none too friendly toward banking institutions, turned strongly to the idea of an independent federal treasury. Such an institution was established in 1846.⁶ It had its justification in the unstable and unregulated condition of the banking institutions of the time, which were in reality unsafe and unreliable custodians of the public funds. Bagehot remarks that in the infancy of banking it is much better that a government should keep its own money. If there are no banks in which a government can place secure reliance, he adds, it should not seem to rely on them. Political as well as economic conditions militated against any control of the state banks during the forties, effective enough to qualify them as satisfactory public depositaries, and the collapse of the federally controlled Second Bank left no safe alternative open to the government.⁷

The independent Treasury. The subsequent history of this subject falls roughly into three periods. The first occupies the years 1846 to 1861. During this time the policy of separation and segregation of the govern-

⁶ A preliminary law was passed in 1841, but it was in effect only a few months.

⁷ D. Kinley, *The Independent Treasury*, p. 52. Publications of the National Monetary Commission (1910).

ment money and its fiscal operations was more or less completely carried out. Federal revenues were paid in coin or treasury notes, the money was kept in the treasury vaults in Washington or in some one of the sub-treasuries which were established in different cities. Disbursements were made in coin or notes from these treasury agencies. The Mexican War loans were floated directly by the Treasury Department without the aid of banks. Even in this period, however, the accumulation of surplus funds in the Treasury led to efforts at relief of the money market through bond purchases at fancy premiums, with a view to putting the money into circulation.

The second period runs from 1861 to 1920. It is marked by the abandonment of the theory of the independent Treasury, and the more or less complete return to the system of a government alliance with, and dependence upon, the banks which were used both as public depositaries and as fiscal agents of the government in placing loans, effecting transfers of money, issuing paper currency, and various other financial operations connected with the transaction of the public business. The third period begins with the repeal of the subtreasury act in 1920.

It is unnecessary to elaborate the details of this reversal of the earlier treasury policy. The isolation of funds is no longer tenable after banking practice and standards of control have evolved to a level which affords the government a suitable measure of protection. There were evidences of the impossibility of maintaining a rigorous separation, even before the Civil War. The financial problems of that conflict were beyond the capacity of the Treasury to solve single-handed, and the banks were requested to aid in providing funds. Secretary Chase's policy of issuing government demand notes with one hand while gathering in the banks' cash reserves as a loan with the other, hastened the collapse of these institutions, an event that forced the Treasury also to suspend specie payments. This outcome was probably unavoidable, in view of the determined attempt that was made to rely on loans rather than taxes for financial support. It might have been delayed, however, by a different attitude of the Treasury toward the banks, and a policy of frank coöperation with them.

The national banking system was established in 1863 under federal control for the express purpose of providing a market for government bonds and assuring the country a uniform and stable currency. The national banks were utilized from the outset as depositaries of the public money. In the beginning federal deposits were restricted to the collections under internal revenue laws, but later the deposit of customs receipts was also authorized, a significant step in view of the historic position of the customs in the scheme of federal revenues. The earlier construction of the subtreasury law distinguished between the eight or nine subtreasuries as branches of the Treasury proper, and the depositary banks. The Sec-

retary of the Treasury was deemed, under this construction, to have no authority to transfer funds actually within the Treasury to a depository bank. This construction was abandoned in time and the federal moneys were freely moved about between the subtreasuries and the banks as conditions appeared to require.

As the magnitude of the government's financial operations grew, the effects of an alternate collection and disbursement of the public funds upon general economic conditions became increasingly serious. The devious interpretation of the subtreasury law, and the resulting manipulation of the government funds, were regarded as a necessary antidote to the financial "chills and fever" produced by the alternate withdrawal and release of large sums in the course of Treasury operations. Successive secretaries of the Treasury undertook increasingly liberal measures for the relief of the money market, the climax being reached in the years prior to the panic of 1907.⁸ The statutory modification of the subtreasury law, together with the further informal modifications by the process of administrative construction, meant the complete abandonment of the independent Treasury idea, without an adequate legal recognition of this fact. The Secretary of the Treasury was the possessor of too great power over the federal funds, and his manipulation of these between the depository banks and the Treasury was too frequently subject to determination on arbitrary or personal grounds. This is never a safe basis on which to settle important fiscal matters.

The independent Treasury was no more successful in its services as fiscal agent of the government than in its capacity as custodian of the funds. The flotation of the Civil War loans by the Treasury proved impossible from the outset, and the aid of a private sales force was enlisted, as well as the support of the banks. It is generally recognized that the resumption of specie payments in 1879 could hardly have been accomplished without the cooperation of the banks in not presenting their large holdings of legal tender notes for redemption. Again, during the depression following the panic of 1893, the Treasury's attempts at loan flotation failed and it was necessary to resort to the services of a banking syndicate.

The Spanish War loans of 1898, which were offered directly by the Treasury, were heavily oversubscribed, but this is to be ascribed to the popularity of the war, to the fact that a banking syndicate had guaranteed the loan, and to the very favorable price at which the government was offering the bonds.⁹

The reserve banks as fiscal agents. The obsolete character of the independent Treasury was formally recognized in 1913, when the system of federal reserve banks was created. Section 15 of the Federal Reserve

⁸ Kinley, *op. cit.*, pp. 125 ff.

⁹ See *ibid.*, Ch. XII.

Act authorized the use of these banks as fiscal agencies in the following language:

The moneys held in the general fund of the treasury, except the 5 per cent fund for redemption of outstanding national bank notes and the funds provided in this act for the redemption of Federal Reserve notes may, upon the direction of the Secretary of the Treasury be deposited in the Federal Reserve Banks, which banks, when required by the Secretary of the Treasury, shall act as fiscal agents of the United States; and the revenues of the government or any part thereof may be deposited in such banks, and disbursements may be made by checks drawn against such deposits.

No public funds of the Philippine Islands or of the postal savings, or any government funds, shall be deposited in continental United States, in any banks not belonging to the system established by this Act. Provided, however, that nothing in this Act shall be construed to deny the right of the Secretary of the Treasury to use member banks as depositaries.

The authority conferred upon the Secretary of the Treasury by this section was not exercised until January 1, 1916.¹⁰ The delay was for the purpose of affording the new banks opportunity to become well established before requiring of them this additional service for the government. In the meantime the policy was continued of counteracting untoward tendencies in various sections of the country by the deposit of government funds. In each of the three years, 1913, 1914 and 1915, "crop-moving deposits" were made with the banks of the South and West for the purpose of influencing local interest rates and supplying additional credit accommodation for these sections. In connection with the 1913 allotment, the banks were permitted to advance as security for the deposits high-grade commercial paper at 65 per cent of its face value, and bearing the indorsement of the depositary bank. This was said to be an unprecedented step in the history of such deposits.¹¹

The designation of the reserve banks as depositaries and fiscal agents did not necessarily involve the elimination of other depositary banks, for the right to select other banks as depositaries was expressly safeguarded. This plan was interrupted by the war, and for a time the federal government was compelled to react to the opposite extreme of a widespread use of banks as depositaries. The First Liberty Loan Act authorized the Secretary of the Treasury to deposit in such banks and trust companies as he might designate the proceeds or any part thereof, of the sale of bonds or certificates of indebtedness.¹² These deposits were to bear a rate of interest and to be subject to terms and conditions prescribed by the Secretary of the Treasury. The act further provided that the amount deposited in any bank or trust company should not exceed the amount

¹⁰ Secretary of the Treasury, *Report*, 1915, p. 12.

¹¹ *Ibid.*, 1913, p. 2.

¹² *First Liberty Loan Act*, Section 7.

withdrawn for investment in the bonds, plus the amount so invested by the bank itself.

The step marked the beginning of a system of special depositaries which has since continued, and which has been characterized by very close relation between the banks and the Treasury. The second loan act authorized the designation of depositaries in foreign countries as a means of facilitating payment of army and navy expenses,¹³ while the fourth loan act contained the additional provision that any bank or trust company designated as a depositary might act as a fiscal agent of the United States in selling or delivering any bonds, certificates of indebtedness or war savings certificates.¹⁴

Still closer relations were established between the Treasury and the banks by the arrangement, inaugurated in 1917, whereby the depositary banks were permitted, under certain conditions, to pay for bond subscriptions by means of a credit on their books to the account of the Treasurer of the United States.¹⁵ These credits were drawn against, either directly or by means of transfers to the federal reserve banks, and the disbursement operations resulted, therefore, simply in a transfer of credits among the banks. This was part of the general policy of issuing loans on the basis of bank credits rather than of actual savings, which has already been described.¹⁶ The economic wisdom or unwisdom of the practice is not here in question. It is mentioned to illustrate the growing interrelation of treasury and banking operations. It appears reasonable to conclude, however, that the arrangement facilitated credit inflation by promoting the ease of bank payment for government loans.

A large proportion of the total government balance was regularly kept in the special depositaries, and when funds were to be called for, the federal reserve banks apportioned the amount needed among all the banks on a pro rata basis.¹⁷ The original object of the special depositaries was to secure widespread diffusion of the government securities over the country and to avoid undue concentration of the public funds into certain banks.

In this connection it is desirable to emphasize a point that has been dwelt upon throughout this book. This is the proposition that the government should never take advantage of its power over the banks or over individuals to obtain favors or advantages which cannot be justified on sound financial or banking principles. The practice of relieving the depositary banks, regular and special, from the obligation of carrying a

¹³ *Second Liberty Loan Act*, Section 8.

¹⁴ *Fourth Liberty Loan Act.*, Section 4.

¹⁵ Treasury Department Circular, 79, Secretary of the Treasury, *Report*, 1917, p. 131.

¹⁶ *Supra*, pp. 621-624.

¹⁷ J. M. Chapman, *Fiscal Functions of the Federal Reserve Banks* (1923), pp. 127, 162.

reserve against the government deposits is a case in point.¹⁸ These banks were required to deposit approved collateral security in lieu of maintaining a reserve, but this departure from sound banking practice is of doubtful propriety. The government's deposits are payable at call, and, like any other, should be safeguarded by a reserve. As long as this practice continues, the government cannot be said to be making use of the banks on the same terms as their private customers.

Abolition of the subtreasuries. The next and final step in the development of the policy of handling the federal moneys was taken in 1920, in the abolition of the subtreasuries and the distribution of their assets, functions and personnel among various other federal agencies. The step had been recommended by the Bureau of Efficiency to which the question of the future of the subtreasury system had been referred.¹⁹ The various subtreasuries were closed during the year 1920-1921, and their duties were assigned in part to the federal reserve banks, in part to the mints and assay officers, and in part to the Treasurer of the United States, in accordance with the law authorizing their dissolution.²⁰ In view of the developments of the past generation these offices were obsolete, and their position in the federal administrative structure had chiefly a political rather than a fiscal significance.²¹

The government continues to maintain general deposit accounts with the member banks, in order to accommodate disbursing officers and federal collectors located at points remote from the reserve banks. The number of such depositories and the volume of their accounts have varied materially. In general, the tendency has been to eliminate the small, relatively inactive accounts. Since 1928 state banks and trust companies have been authorized, when duly qualified, to act as financial agents and to carry public deposits.

The magnitude of the financing operations during the second World War involved the accumulation of large and growing federal deposit balances in the banks. Table LXI shows these balances at the year-end from 1940 to 1945.²²

Beginning in April, 1943 banks were not required to carry reserves against government deposits arising out of the purchase of war loan paper by them, until after six months from the end of hostilities. At the end of December, 1945, government deposits in federal reserve banks were \$1,674 million. The total balance in the Treasury general fund at that time

¹⁸ *Ibid.*, pp. 133, 134.

¹⁹ *Report of the Bureau of Efficiency*, Ch. 1639. The United States Statutes of 1917 (Ch. 642) directed the Bureau of Efficiency to study this question.

²⁰ *Appropriation Act of 1920* (Ch. 214 of Laws of 66th Congress, 2nd Session).

²¹ M. S. Wildman, "The Assumption of Treasury Function by the Federal Reserve Banks," in *Annals of the American Academy of Political Science*, Vol. XCIX, p. 129 (January, 1922).

²² *Federal Reserve Bulletin*, February, 1946, p. 157.

was \$26 billion, consisting principally of the above classes of deposits. The budget message for the fiscal year 1947 proposed to apply \$21,471 million of this balance toward the deficits anticipated for the fiscal years 1946 and 1947.²³

TABLE LXI
UNITED STATES GOVERNMENT DEPOSITS IN BANKS
(MILLIONS OF DOLLARS)

<i>End of December</i>	<i>Amount</i>
1940	\$ 753
1941	1,895
1942	8,402
1943	10,424
1944	20,763
1945	24,600 *

* preliminary

A division of deposits was created in the Treasury, in 1920, and charged with the administration of all matters pertaining to the designation of depositories, the deposit of funds in the federal reserve banks, national banks and special depositories. It is also to have supervision of the deposits and the provision of proper security for government deposits. All regulations relative to the procedure of depositing public money by collectors and other officials are prepared by this division with the approval of the Secretary of the Treasury.²⁴

The changes that have been outlined above have brought the United States into the ranks of the countries which utilize the services and the facilities of great central banks in the collection, safe-keeping and disbursement of the public money. These changes have greatly simplified the procedure of collection and disbursement, and have diminished, although not entirely eliminated, the periodic influence of large tax payments upon general money conditions. The arrangements set up by the reserve banks for equalizing the clearing transactions in different sections apply also to the government operations, which are cleared along with other checks and drafts. Such disturbance to bank rates and general financial conditions as remains is a necessary incident of the large amounts that must be transferred from private accounts in the process of tax settlement. The stringency is but momentary, however, for the reserve banks are in funds very shortly after the quarterly tax settlement days, and are able to relax interest rates by reason of their mounting balances on the government account. The use of treasury bills and certificates tends to relieve the severity of the periodic stringency which might otherwise develop. In any event the situation is much improved over that which prevailed under the subtreasury system, for the money remains

²³ *Budget Message for the Fiscal Year 1947*, p. lxxviii.

²⁴ *Secretary of the Treasury, Report*, 1920, p. 176.

in possession of the reserve banks, and is not as definitely segregated as it was likely to be under the other plan.

Prior to 1908 the Treasury charged no interest on its deposits in the banks. The latter were required to provide collateral security of such character and amount as might be determined by the construction of the law by any given Secretary of the Treasury, but they were allowed the use of the government funds without charge, pending their withdrawal by the treasurer. In that year the policy was introduced of charging interest at 1 per cent on the "inactive accounts," which included all special or temporary deposits and all sums held by regular depositaries in excess of the amount needed for the transaction of public business. Beginning with 1913 all banks were required to pay 2 per cent interest on all deposits.

The banking act of 1933 forbade the banks to pay interest on demand deposits unless contracts to pay were in effect at the time the act was passed. The Treasury regarded its depositary arrangements as contracts in this sense but decided to waive future interest charges.²⁵ This was the only way to avoid embarrassment, since all new depositary arrangements must necessarily be on an interest-free basis.

The national gold hoard. The gold nationalization act of 1933 added another chapter to the story. It was written at a time of acute financial hysteria and inordinately rampant nationalism; and under these conditions it was deemed advisable to revert again to the medieval notion of a government hoard of specie. All monetary gold was nationalized, ordered into the Treasury, and arbitrarily increased in value by devaluation of the dollar. The jingoes went so far as to plan huge storage vaults for this gold at some remote inland point, on account of the vulnerability of Washington to foreign attack, evidenced by the experience of 1814. The Treasury will release gold for foreign payment, and the reserve banks are given gold certificates for reserve purposes. By such means a gold currency standard is maintained, but the ultimate wisdom of abolishing a completely free use and ownership of gold remains to be demonstrated.

The Treasury has also accumulated a vast hoard of silver under the extremely ill-advised silver purchase legislation of 1934. The folly of this course has already been amply demonstrated.

THE CUSTODY OF STATE AND LOCAL FUNDS

The problems presented by the collection and disbursement of state and local funds have to do mainly with matters of safe-keeping, and the provision of adequate responsibility for the custody of these funds, rather than with the larger questions of the economic effect of the fiscal operations. In contrast to the federal government, a characteristic in-

²⁵ *Annual Report of the Secretary of the Treasury*, 1933, p. 70.

difference was displayed by the state and local governments especially in their earlier history, to some important aspects of the custody and disposition of public funds. Indeed, the legislation on this subject at the present time is far from uniformly good.

The office of treasurer has been a regular feature of the framework of governmental organization for both state and local governments. This officer has usually been charged with the collection of the revenues, although various taxes and fees have been collected by other officials, in all of the states. Early legislation frequently went little farther than to provide that the treasurer should be the custodian of the moneys collected, and to provide some arrangement for bonding this official. As a rule the state constitutions copied from the federal constitution the provision to the effect that no money should be drawn from the treasury except in consequence of appropriations made by law. But both constitution and statute were exceedingly vague as to what constituted the treasury, and quite defective in the accounting and auditing procedure set up to afford a check on the deposit and withdrawal of funds. The loose methods and the lack of accountability on the part of various officials opened the door to serious misuse of the public funds in more than one state. The evils that developed in Ohio are thus summarized by the historian of the state finances.²⁶

It is impossible to say just when lack of responsibility led to misapplication of public funds, or speculation became peculation, but it may certainly be placed as early as 1838. The report of the examining committee in 1845 showed that from about that date down to the time of their report, corruption, fraud and graft were present on the canals, in the letting of contracts to high bidders, in collusive bids, in contracts by state officials, etc. Debts due the state were uncollected, overpayments were made to favored contractors, the contingent fund at the disposal of the acting canal commissioners was loosely used, and other corrupt practices were introduced. The public funds were deposited in favored banks; originally introduced to facilitate payments at distant points, the system seems to have been abused.

Despite the enactment of various futile corrective laws, the abuses continued and culminated in the grand defalcation of 1857, when the state treasurer admitted a deficit of \$580,313. This represented the accumulated stealings of three treasurers over a decade. Each in turn operated the office for his own profit, while he concealed—and thereby assumed—the deficit of his predecessors.²⁷

Following this experience Ohio introduced, in 1858, an independent treasury, with a vastly more effective system of auditing control than had been in use before. No money was to be deposited in banks, for these had been the source of much of the earlier fraud and corruption.

²⁶ E. L. Bogart, *The Financial History of Ohio*, pp. 154, 155.

²⁷ *Ibid.*, pp. 161 ff.

Their influence grew out of the practice which was universal until checked by drastic legislation and accounting control, of permitting custodians of public funds to deposit their money in the banks and receive the interest thereon as a perquisite of the office. This practice was commonly engaged in even when the law forbade it, because public opinion sanctioned the custom rather than the law. City, county and township treasurers followed the example set by the state treasurer, and the freedom of handling the public money which inevitably resulted opened the way to speculation and, in many instances, to embezzlement.

The Ohio law of 1858 provided that the rooms of the state treasurer in the capitol building were to constitute the state treasury, and were to be the sole place for the deposit and safekeeping of the state money. The county commissioners were also directed to establish county treasuries, in which the local funds were to be kept. The Ohio independent treasury system was defective at certain points, but it did provide a system of checks upon the handling and use of the state money which eliminated the graft and corruption of the earlier régime. The plan was abandoned in 1894 for a system of depositing state funds in banks and trust companies called depositories and designated, after competitive bidding, by a state board of deposits.

The earlier financial history of other states would doubtless reveal many points of similarity to the experience of Ohio, in the looseness that characterized the handling of public funds and the development of more careful and adequate checks and safeguards against fraud and misuse. A legislative investigation of the books of the treasurer of Wisconsin in 1856 revealed many evidences of loose methods. Erasures, alterations and substitution of other names abounded. The entries were in a confused state, some vouchers were missing, while others offered no evidence of payment to anyone. Money was being paid to persons who merely expected appropriations, while state officials and employees often drew their salary in advance, leaving slips "for so many dollars." A deficit of \$34,973 was disclosed in 1856; of which only about \$3,500 was ever recovered.²⁸ In 1894 Wisconsin secured judgments against former treasurers aggregating \$327,902 on account of the misappropriation of interest on state funds.²⁹

Many of the states have now developed an adequate system of auditing control over state funds, and all of them now have some sort of legislation for the protection of public deposits. In all but five states³⁰ the depository banks must either give an approved surety bond or pledge approved collateral security. A further limitation is set, in most states,

²⁸ R. V. Phelan, *Financial History of Wisconsin*, pp. 283 ff.

²⁹ Secretary of the State of Wisconsin, *Report*, 1893-1894, pp. 29, 30.

³⁰ Colorado, Connecticut, Massachusetts, New Hampshire, and North Carolina. Cf. summary of public depository legislation by Martin L. Faust, in *Tax Systems of the World* (1935) pp. 220-223.

upon the amount that may be deposited in any bank. This limit may be either a fixed amount or a certain percentage of the bank's capital, surplus and undivided profits.

These laws continue to provide for allocation of deposits chiefly on the basis of the rate of interest that the banks will agree to pay on the deposits. The rate is set either by official action or by competitive bidding. This practice must become increasingly inoperative in time on account of the prohibition of interest on demand deposits in the banking act of 1933. The restriction did not abrogate existing contracts but it forbade interest agreements in new contracts. Eventually the states will face the alternative of an undesirable concentration of public deposits in the banks with which they had such agreements in 1933 or of foregoing the whole arrangement, since it is impossible to exact interest in some cases but not in others. The federal treasury has already acted in this dilemma by dispensing with the interest requirement.

State and local units have always faced certain difficulties in selecting their depository banks. If the conditions of qualification were relaxed, charges of favoritism were always cropping up, and were sometimes justified. While competitive bidding appeared to eliminate this evil by investing the selection of depositories with a certain straightforward business aspect, it has never been wholly satisfactory on account of the temptation to offer more than the privilege was really worth from a banking standpoint. As the interest basis of allocation is eliminated, the problem of selection must again be faced and solved on some other basis.

As long as the current distorted and perverted notions prevail with respect to the nature of demand deposit banking, the future of public deposits in banks is precarious. There is none too much evidence as yet that enough has been learned from the bitter experiences of the early thirties to assure correction of the practices that were so material a factor in the bank debacle. Until there is a return to sanity in banking, the states and their subdivisions can only follow the advice of the pioneer—"trust in the Lord and keep the powder dry." The latter half of this injunction, in the present instance, consists in strict provisions regarding surety, limitation of amounts, preferably in relation to capital and surplus, and geographical diffusion.

Selected Bibliography

In the earlier editions, references were supplied at the end of each chapter. The advantage of such material is that it supplies the student who wishes to explore further a given topic with specific citations to books or documents dealing with it. It may be doubted, however, if much actual use is ever made of such references. The substantial number of footnote references serve the same purpose, in any event. There is provided here a short list of titles, some of which have not been cited in the text.

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